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## 2002-2003 LEONARD V.B. SUTTON AWARD



## BOOK REVIEW

# THEMES AND VARIATIONS: THE CONVERGENCE OF CORPORATE GOVERNANCE PRACTICES IN MAJOR WORLD MARKETS

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## INTRODUCTION

The generally accepted definition of the phrase "corporate governance" comes from the seminal report of the Committee on the Financial Aspects of Corporate Governance, which was chaired by Sir Adrian Cadbury.[1] The Cadbury Report defines corporate governance as "the system by which companies are directed and controlled."[2] It has been defined by others as "a system of checks and balances between the board, management and investors to produce an efficiently functioning corporation, ideally geared to produce long-term value."[3] At its most basic, corporate governance deals with the relationships among various stakeholders with respect to the control of corporations. Above all, corporate governance addresses the relationship between the owners of a company – the shareholders who are the principals—and those who manage the company's operations – the executives hired to run the company as agents of the principals.[4] Corporate governance encompasses the weight given to various factors in connection with the process for making strategic decisions, the adequacy and transparency of disclosures, the reliability of financial reporting, and compliance with laws and regulations.[5]

Over the past several years, scholars have written extensively about the con-

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1. Report of the Committee on the Financial Aspects of Corporate Governance (Dec. 1, 1992), *available at* www.worldbank.org/html/fpd/privatesector /cg/docs/cadbury.pdf (last visited Feb. 1, 2004) [hereinafter *Cadbury Report*].

2. *Id.* at § 2.5.

3. *Governance and Executive Compensation: Hearing Before the Senate Committee on Finance*, 107th Cong. 2 (2002) (testimony of Dr. Carolyn Kay Brancato, Director, Global Corporate Governance Research Center, The Conference Board, before the Senate Finance Committee on April 18, 2002, at 2), *available at* http://finance.senate.gov/hearings/testimony/041802cbtest.pdf (last visited Feb. 1, 2004).

4. *Cadbury Report*, *supra* note 2, at § 2.5.

5. *See id.*

vergence of corporate governance practices around the world.[6] In the post-Enron era and with the passing of the first anniversary of the Sarbanes-Oxley Act,[7] we can clearly see that the pace of change has hastened; in some markets where corporate governance was nascent, it has advanced considerably in a short period of time as regulators around the world are united by a desire to restore the confidence of investors in the world's securities markets. Despite the swift change, the convergence of governance practices will never be complete for many reasons, although certain core principles will be recognized in virtually every country as fundamental to a market economy

This article reviews some of the factors affecting this convergence process and also looks at the status of convergence between the United States' governance laws and practices and those of certain other major markets. Specifically, the article briefly reviews recent corporate governance changes in Canada, Germany Japan, Mexico and the United Kingdom from the perspective of a practitioner who has been involved in various governance issues in subsidiaries and acquisitions in these markets. In each of these countries, one constant is that the corporate governance principles to which companies are subject are imposed through several sources. In the United States, for example, principles of corporate governance applicable to a public company created under the laws of Delaware are derived from the Delaware General Corporation Law,[8] state and federal securities laws, and the listing standards of any stock exchanges upon which that company's stock is listed.[9]

## FACTORS AFFECTING CONVERGENCE

Internal and external factors influence companies to establish good governance practices. While certain factors that influence companies in the area of corporate governance are specific to the country, or even the state or province in which a company is domiciled, many of these factors transcend geographic borders. Many different factors, such as the philosophical approach, market forces, political forces

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6. *See generally* Douglas M. Branson, *The Very Uncertain Prospect of 'Global' Convergence in Corporate Governance*, 34 CORNELL INT'L L.J. 321 (2001); William W Bratton & Joseph A. McCahery, *Comparative Corporate Governance and the Theory of the Firm: The Case Against Global Cross Reference*, 38 COLUM. J TRANSNAT'L L. 213 (1999); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641 (1999); Gustavo Visentini, *Compatibility and Competition Between European and American Corporate Governance: Which Model of Capitalism?* 23 BROOK. J. INT'L L. 833 (1998); Edward B. Rock, *America Shifting Fascination with Comparative Corporate Governance*, 74 WASH. U. L. Q. 367 (1996).

7 Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 15 U.S.C. 7201 et seq. (2002).

8. 8 Del. Code §§101 et seq. (2003).

9. *See generally* Hillary A. Sale, *Delaware Good Faith*, 89 CORNELL L. REV. 456 (2004); Robert B. Thompson, *Collaborative Corporate Governance: Listing Standards, State Law, And Federal Regulation*, 38 WAKE FOREST L. REV. 961 (2003); and William B. Chandler, III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PENN. L. REV. 953 (2003).

and the cooperation of various global entities, have played a role in the progress toward convergence.[10]

## THE PHILOSOPHICAL APPROACH TO GOVERNANCE

One impediment to complete convergence is the varying philosophical approach to governance regulations. Some countries approach corporate governance in a manner that differs substantially from the approach adopted in the United States. With the passage of the Sarbanes-Oxley Act and the adoption by the Securities and Exchange Commission of various enhanced corporate governance standards, the United States has progressed even further into a law-based, or rules-based, approach to governance.[11] The legislation, regulations, and stock exchange listing requirements relating to governance are extremely detailed. Failure to comply with these highly specific rules may result in penalties.

Conversely, in some of the world's other markets, the approach is a principles-based approach.[12] In those countries favoring a principles-based approach to the regulation of corporate governance, the government may adopt – or even allow self-regulatory organizations such as the stock exchanges to adopt – general principles of corporate governance.[13] A simple explanation of the difference between the two approaches is illustrated by the different concepts conveyed by the terms "law" and "guideline."[14] The result is a different mindset with respect to corporate governance in the United States, which applies a rule- or law-based approach, where what is not prohibited is permitted, compared to a principles-based approach where greater discretion is vested in a company's management to make decisions regarding governance activities.

A principles-based approach to governance is one in which guidelines are clear, but compliance with them is voluntary Some countries have adopted a "comply or disclose" approach to corporate governance, which requires corporations to disclose whether they comply with governance guidelines.[15] Other countries have adopted a "comply or explain" approach, which requires corporations not only to disclose whether they comply with governance guidelines, but also require the explanation of any reasons for non-compliance.[16] Typically, the compliance or non-compliance disclosure is made in a filing with either the stock ex-

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10. *See generally* Alex Y Seita, *Globalization and the Convergence of Values*, 30 CORNELL INT'L L. J. 429 (1997).

11. *See e.g.*, William W. Bratton, Enron, *Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV 1023 (2003).

12. *See id.* at 1037

13. *See generally* Bratton, *supra* note 11.

14. *See* PIRATES OF THE CARIBBEAN: THE CURSE OF THE BLACK PEARL (Walt Disney Pictures 2003), where the pirate captain, Barbossa, tells Elizabeth, "First, your return to shore was not part of our negotiations nor our agreement, so I must do nothin' And secondly, you must be a pirate for the Pirate's Code to apply, and you're not. And thirdly, the Code is more what you'd call 'guidelines' than actual rules.

15. *See generally* Bratton, *supra* note 11.

16. *See generally id.*

change or a government agency [17]

THE EFFECT OF MARKET FACTORS ON GOVERNANCE

Good corporate governance is of utmost importance in today's economic environment because it affects investors, capital markets and the companies themselves. In a recent study sixty-three percent of investors said that they would avoid investing in certain companies if those companies had poor corporate governance practices.[18] Fifty-seven percent of investors said they would change their holdings in companies based on the corporate governance practices of those companies.[19] In the alternative, investors in many countries are willing to pay substantial premiums to invest in well-governed companies. In Africa and Eastern Europe, the premiums can be as high as thirty percent, while in Western Europe and North America, the premiums are in the low teens.[20]

These same investors indicated that corporate governance can have a profound effect on the capital market of particular countries.[21] Thirty-one percent of investors said they would avoid holdings in certain countries based on the general governance practices in those countries.[22] Companies from around the word compete against each other for capital in the global markets.[23] The need to go outside the country for capital may be due to the lack of depth of the capital markets in a company's home country, or the possibility of obtaining lower rates abroad.[24] Companies from those countries viewed as having lax laws governing transparency and disclosure will have a competitive disadvantage as the rates they pay for capital in the global markets will be higher.[25]

Rating agencies such as Moody's, Standard & Poor's and Fitch now evaluate, in addition to the financial ratios they have always reviewed, governance issues in

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17. *See generally id.*

18. MCKINSEY & COMPANY, GLOBAL INVESTOR OPINION SURVEY: KEY FINDINGS, (2002), *available at* http://www.mckinsey.com/practices/corporategovernance/PDF/GlobalInvestorOpinionSurvey2002.pdf (last visited Feb. 2, 2004).

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. *See generally* Christopher J. Mailander, *Financial Innovation, Domestic Regulation and the International Marketplace: Lessons on Meeting Globalization Challenge Drawn from the International Bond Market*, 31 G. WASH. J. INT'L L. & ECON. 341 (1998).

24. *See* James A. Fanto & Roberta S. Karmel, *A Report on the Attitudes of Foreign Companies Regarding a U.S. Listing*, 3 STANFORD J. OF L. BUS. & FIN. 51 (1997).

25. In meeting of the World Economic Forum in Mexico in 2001, Frédéric Sicre, Managing Director of the Centre for Regional Strategies at the World Economic Forum noted that "Management should not consider corporate governance as a straightjacket, but rather as a means to lower its cost of capital. World Economic Forum, *Mexico Meeting 2001 Report: Managing New Expectations and Old Challenges* at 34, *available at* http://www.weforum.org/pdf/Mexico/Mexico_report_2001.pdf (last visited Feb. 2, 2004).

assigning a debt rating to companies.[26] In a competitive marketplace, the rate at which a company can finance debt is directly related to the company's credit rating.[27] Where a company's risk of default is determined to be high by the ratings agencies, the company must pay a higher rate to raise capital, possibly issuing junk bonds which require high interest rates to compensate investors for the high risk of default, than a company which can issue investment grade bonds.

For the companies themselves, governance can have a great impact. Poor governance, as seen in the media over the past two years, can lead to the implosion of respected and successful companies.[28] Poor governance can also affect stock prices, as investors sell stock in companies that have a reputation for poor governance practices.[29] Not only can poor governance affect companies' stock prices, it may also affect courtroom outcomes. A recent study found that seventy-three percent of jurors believe auditors will lie for their clients, while seventy-eight percent believe companies destroy documents.[30] Particularly in the United States, this mistrust of corporations may lead to larger jury verdicts in the future for corporations that have a reputation for poor governance and, perhaps, for all corporations.

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26. S&P Moody's, and Fitch have been designated by the SEC as Nationally Recognized Statistical Rating Organizations. *See Written Statement of Rating and Investment Information, Inc.. Submitted to the U.S. Securities and Exchange Commission In Connection with the November 15 and 21, 2002 Hearings on Credit Rating Agencies* at 2 (Nov. 14, 2002), *available at* www.sec.gov/news/extra/credrate/ratingsinvest.htm (last visited Feb. 1, 2004). Like corporate America, these groups face increased regulations as a result of recent corporate scandals; they did not downgrade WorldCom or Enron until bankruptcy was inevitable. This was the impetus for these organizations to begin scrutinizing governance at the companies they review. *See e.g.*, Claire A. Hill, *Ratings Agencies Behaving Badly: The Case of Enron*, 35 CONN. L. REV. 1145 (2003).

27. For a discussion of the credit rating agencies and their impact on a corporation's cost of capital, *see generally* Frank Partnoy, *The Siskel & Eberts of Financial Markets?· Two Thumbs Down for the Credit Rating Agencies*, 77 WASH. UNIV. L. Q. 619 (1999).

28. *See* 2002 Report on the Corporate Performance Project, *Conformance & Performance-Corporate Governance: As Conformance Duty-An Assessment of Progress as Performance Opportunity-Is There Real Potential*, World Economic Forum in Partnership with Deloitte Touche Tomatsu, *available at* www.deloitte.com/dtt/cda/doc/content/WEFreport_2002(2).pdf (last visited Feb. 4, 2004).

29. The Brunswick Group, Opinion Research Corporation Study of U.S. Attitudes Toward Companies Facing Litigation, *Litigation: the Bottom Line*, *available at* www.brunswickgroup.com /index_flash.htm (last visited March 29, 2004). The study showed that in 2003 over sixty percent of investors considered selling stock in companies accused of wrongdoing in lawsuit, compared to just over 50% in 2001.

30. Minority Corporate Counsel Association, *DecisionQuest/MCCA Juror Perception Survey Warns of Intense Corporate Distrust by America' Juries* (October 16, 2002), *available at* http://mcca.com/site/data/researchprograms/surveys/dq_mcca_survey_2002.htm (last visited March 29, 2004).

THE EFFECT OF CORPORATE STRUCTURE AND OWNERSHIP DISPERSION ON GOVERNANCE

The type of corporate structure common in some countries can lead to different results in the corporate governance arena. In Germany, for example, there is a two-tiered board structure consisting of a management board called the *Vorstand* and a supervisory board of outside directors called the *Aufsichtsrat*.[31] Members of the *Vorstand* cannot, at the same time, be members of the *Aufsichtsrat*.[32] The existence, at the highest level in the corporation, of a board of independent, outside directors, arguably abrogates the need in Germany for some of the corporate governance principles gaining traction in the United States, such as requiring independent audit or compensation committees.

Ownership dispersion also differs from country to country, creating different governance concerns in some other countries than those that exist in the United States. In the United States and United Kingdom, ownership dispersion is high, while in France, Canada and Germany ownership dispersion is low.[33] The commonplace family or bank ownership structures in Canada, Germany, Japan and Mexico may make investors in those cultures more comfortable with control of the corporation resting in a limited number of individuals having a high percentage of ownership. Differences in the number of individual investors in comparison to institutional investors may also lead to apposite results in various countries. Institutional investors can be expected actively to monitor firm performance because of the expertise they possess.[34] Further, their large ownership stakes motivate them to engage in active monitoring.

In Japan and the United Kingdom, for example, companies may have commercial dealings with many banks, but rely heavily on one main bank as their primary source of funds.[35] These banks may exercise very little control during period of smooth sailing. Until the company faces a crisis, the banks are likely to eschew intervention. When a crisis occurs, the banks become more active, exercising their rights as lenders and at times, substantial shareholders, to guide the company through the crisis or oversee reorganization by replacing management, restructuring debt and trimming expenses.

During the past two decades, institutional investors such as mutual funds and

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31. DR. THOMAS KUSTOR, DIRECTORS AND OFFICERS LIABILITY IN AUSTRIA at 1b, 2 (Freshfields Bruckhaus Deringer, July 2002), *available at* http://www.aiu.com/aiu/PDF/Austria.pdf [last visited March 29, 2004] (discussing the Limited Liability Company Act (GmbH-Gesetz), and The Stock Corporation Act (Aktiengesetz)).

32. *Id.* at 2.

33. Eric R. Gedajlovic & Daniel M. Shapiro, *Management and Ownership Effects: Evidences from Five Countries*, 19 STRATEGIC MGM'T J. 533, 536 (1998).

34. *See e.g.*, David Bank, *CALPERS Won't Back 5 Directors of H-P in Protest of Auditing*, WALL STREET JOURNAL, March 11, 2004 and Tim Burt & Christopher Parks, *The Walt Disney Crisis: A 'Resounding Victory' for Shareholders*, FINANCIAL TIMES, March 5, 2004.

35. For discussion of the Japanese Banking System, *see generally* THE JAPANESE MAIN BANK SYSTEM: ITS RELEVANCE FOR DEVELOPING AND TRANSFORMING ECONOMIES (Masahiko Aoki & Hugh Patrick eds., 1994).

pension funds have played an increasingly important role in corporate governance on both a domestic and international level. To some degree, this is the natural effect of the premium investors will pay for well-governed companies in markets recognized as leaders in the areas of transparency and adequate disclosure. Increasingly, however, these institutional investors act as internal insurgents proac tively attempting to influence corporations by issuing corporate governance statements[36] and filing shareholder proposals.

The institutional investors will also vote against certain management proposals viewed by the investors as lacking the hallmarks of good corporate governance. For example, most institutional investors will vote against any proposed stock option plan that does not explicitly prohibit the repricing of options.[37] Institutional investments originating in the United States dominate those from other countries. Thus, the type of activism that institutional holders here exert will likely become more prevalent abroad over time. Another effect is that there is pressure exerted by these investors to bring disclosure in other markets up to the levels of disclosure United States investors have learned to expect. The activism of institutional holders helps to shape the goals set by companies with respect to governance.[38] It also helps determine the speed at which various governance issues are addressed by both companies and governments and how issues are prioritized.

This institutional investor activism, which has been prevalent for years in the United States, is being actively exported in the post-Enron era. The California Public Employees Retirement System (CalPERS), for example, has identified several "Global Corporate Governance Principles" that are, in its view, minimum standards of corporate governance.[39] CalPERS takes the position that in all markets, companies should adhere to these standards to attract investment from institutional holders.[40] In April of 2003, CalPERS issued a press release in which it announced a $200 million investment in The Taiyo Fund.[41] The fund, based in Japan, will function within Japan as an activist investor much as CalPERS has in the United States.[42] The Taiyo Fund, to avoid dissipating its influence, will make significant investments in a relatively small number of companies to effect change in the area of corporate governance in Japan.[43]

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36. *See e.g.*, California Public Employees' Retirement System (CalPERS), *Global Corporate Governance Principles* at 3, *available at* http://www.calpers-governance.org/principles/international/global/page01.asp (last visited Feb. 1, 2004) [*hereinafter CalPERS Global Corporate Governance Principles*].

37. *See generally* Randall S. Thomas & Kenneth J. Martin, *The Determinants of Shareholder Voting on Stock Option Plans*, 35 WAKE FOREST L. REV. 31 (2000).

38. *See generally* Klaus Eppler & Paul A. Kemnitzer, *Corporate Governance Activities of Institutional Investors and Other Activists*, 1353 PLI/Corp 11 (2003).

39. *CalPERS Global Corporate Governance Principles*, *supra* note 36, at 5.

40. *Id.*

41. Press Release, CalPERS, *CalPERS Invests $200 Million in Japan Corporate Governance Fund* (Apr. 14, 2003), *available at* www.calpers.ca.gov/whatsnew/press/2003/0414a.htm (last visited Feb. 1, 2004).

42. *See id.*

43. *Id.*

THE EFFECT OF COMPENSATION PRACTICES ON GOVERNANCE

Compensation practices in various countries also play a role in the development of governance practices. Boards of directors use base salaries, bonuses and equity awards, such as stock options or restricted stock, to compensate a corporation's senior management. Certain types of compensation more closely align the interests of the company's management with the interests of the company's owners. For example, long-term incentive plans and stock options will in theory encourage company managers to act in harmony with the long-term good of the company rather than making rash, short-term decisions. Institutional investors pay close attention to compensation practices because compensation that is too generous can dilute their ownership over time. Many institutional holders make it a practice to vote against certain types of compensation plans based on corporate governance concerns. For example, Institutional Shareholder Services recommends that institutional holders routinely vote against any stock option plan that does not explicitly prohibit the repricing of options. Institutional holders also pushed companies to expense stock options out of a sense that certain companies, had they expensed options all along, would not have shown a profit.[44]

Some institutional investors view executive pay issues as a touchstone for whether the board properly oversees the management of the company After all, the board of directors has been elected by the company's owners – the shareholders – to, among other things, hire the executives to run the company on their behalf. Those executives report to the board of directors. If the executives' pay is too high, it results from a board that may be too easily swayed by a powerful personality or by the cache or remuneration of board service.[45]

THE EFFECT OF THE MARKET FOR CONTROL ON CONVERGENCE

Cross-border mergers and acquisitions may also affect corporate governance views and practices. As a company in the acquisition mode examines various target companies in a particular market, it will pay a premium for the well-governed target company. The due diligence process that occurs in connection with an ac

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44. *See generally* Stephen Taub, *Coke to Treat Options as the Real Thing*, CFO.com, *available at* http://www.cfo.com/article/1,5309,7452,00.html?f=related (last visited March 29, 2004).

45. D. Quinn Mills, *Paradigm Lost: The Imperial CEO*, 4 DIRECTORS & BOARDS 27 41 (Summer 2003). Professor Mills makes the observation that:

> Initial efforts to retrain strong CEOs have not been promising. Boards have begun to cut back the severance packages of retired or resigned CEOs, especially those under investigation for fraud. Some boards are said to be getting less generous with pay packages. But salary and perks are not the key to the imperial CEO power is. Excessive pay is but a reflection of the dominant position that most CEOs have in their companies. Unless the disproportionate power of the dominant CEO is addressed, it will soon provide him or her a way to again push compensation up dramatically and again afford the independence from checks and balances that enables investors to be defrauded.

*Id.* at 42.

Mills also observes that board rooms often have "club-like atmosphere" because many directors are themselves CEOs or former CEOs. *Id.*

quisition involves, among other things, examining the governance of the target company, the independence of its directors, the quality of the company's financial reporting and disclosure and the existence of related party transactions between the company and its officers or directors. Similarly, a corporation "window dressing" itself to be an attractive target may implement widely-recognized touchstones of good governance to increase its price.

Even if a company is not a takeover target, as companies from other countries enter into strategic alliances, joint ventures and other similar arrangements, these partnerships will hasten the convergence of governance principles. A United States company entering into a joint venture with an established company in a particular market will expect of that company a certain level of governance discipline. Further, the agreements documenting the relationship between the two companies may put into place governance mechanisms over the business that are designed to provide the American company a level of comfort in the governance of the jointly-run business.

Even within the country, underperforming firms will be purchased by rival firms that are more competitive. In theory, these more competitive firms are so, in part, because strategic decisions are made within a governance structure that allows the best decisions to be made. Decisions that focus on the long-term health of the company rather than ones that serve no purpose other than to entrench management in the company are made.

## THE EFFECT OF LISTING STANDARDS ON CONVERGENCE

One factor playing an increasingly important role in the global convergence of corporate governance principles is the listing of certain global companies with the stock exchanges of multiple countries. Each major stock exchange requires that the companies whose stock is traded on the exchange comply with certain listing requirements, many of which directly address issues of corporate governance.[46] There are, for example, approximately 200 interlisted Canadian companies[47] which must comply with not only the Toronto Stock Exchange listing requirements but also the listing requirements of the United States exchange upon which they are listed.[48] Foreign companies have been encouraged to access capital through participation in the United States capital markets.[49] American companies are also ac

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46. *See e.g.*, THE TORONTO STOCK EXCHANGE COMPANY MANUAL, *available at* www.tse.com/en/productsAndServices/listings/tse/resources/resourceManual.html (last visited Feb. 4, 2004); THE LISTED COMPANY MANUAL OF THE NEW YORK STOCK EXCHANGE, *available at* www.nyse.com/listed/p1020656067970.html (last visited Feb. 4, 2004); LISTING STANDARDS OF THE BOLSA MEXICANA DE VALORES, *available at* www.bmv.com.mx; ADMISSION AND DISCLOSURE STANDARDS OF THE LONDON STOCK EXCHANGE, *available at* www.londonstockexchange.com/about/pdfs/admiss_standards_2002.pdf (last visited Feb. 4, 2004).

47. *Keeping Up*, CORP SECRETARY 22 (Aug.-Sept. 2003).

48. The Ontario Securities Commission has been lobbying the Securities and Exchange Commission to allow Canadian inter-listed companies to comply only with the Canadian regulations and not United States rules. CORP SECRETARY 10 (Feb./March 2003).

49. Roel C. Campos, *Embracing International Business in the Post-Enron Era*, Remarks at the

tively courted by foreign stock exchanges.[50] As companies seek to comply with multiple listing standards in various countries, those companies may influence global corporate governance in much the same way that global accounting standards have been influenced by multinationals.

Related to the issue of listing standards is the desire of stock exchanges of other countries to give American investors access to the markets in those countries through the use of trading screens in the United States. Several European Union exchanges, in particular, have sought this access.[51] Under the Securities and Exchange Commission's rules, stock exchanges must register with the Commission to offer and sell securities to the public.[52] Further, the securities listed on those exchanges must be registered with the SEC. These exchanges oppose the idea of registration with the SEC and argue that governance by their home country is sufficient. They are also limited because the exchanges could not, through the mere act of registering, force all of the companies listed upon them to register with the SEC. The SEC, above all, is in business to protect investors. The Commission remains concerned that granting other exchanges access to investors on terms different than the terms with which exchanges here must comply creates a competitive advantage for the foreign exchanges. The depth of this country's capital markets is a testament to the SEC's long-standing successes in protecting investors; opening the door to foreign exchanges here without appropriate controls could limit the SEC's ability to exercise the same control in the future.

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Centre for European Policy Studies (June 11, 2003), *at* http://www.sec.gov/news/speech/spch061103rcc.htm (last visited Feb. 4, 2004). The Commissioner stated:

> .I wish to reaffirm a simple message: European and other non-U.S. market players are welcome and encouraged to participate in the U.S markets. The SEC has facilitated foreign participation in the past and will continue to do so, all within the framework of protecting investors through our existing securities regulation. With this philosophy in mind, over the past 70 years of the SEC's existence, we have afforded equal treatment to all market participants. Few distinctions have been made based on the domicile of the issuer or service provider. After all, US investors are entitled to the same protections regardless of whether an issuer is foreign or domestic. In addition, placing US market participants at competitive disadvantage negatively affects the vibrancy of US markets and, ultimately, would hurt US investors. Shielding US firms from foreign competition, however, would deprive US investors of the benefits derived from the services and products offered by non-US competitors.

*Id.*

50. OTC CONSULTING & FINANCIAL SERVICES, DUAL LISTING IN GERMANY, *at* http://www.duallisting.com/index.php (last visited Feb. 1, 2004). This is reference to the DAX marketing materials inviting American companies to consider dual listing on the DAX as well as United States exchanges. Interestingly, blue chip companies' stock is often listed on those exchanges anyway, through programs similar to the unsponsored American Depository Receipt programs initiated by major banks in the United States to "list" the stocks of prominent foreign firms.

51. *See* ICGN, *ICGN History*, at www.icgn.org/history.html (last visited March 29, 2004), and ICGN, ICGN *Statement on Global Corporate Governance Principles* (July 9, 1999), *at* http://www.icgn.org/documents/globalcorpgov.htm (last visited March 29, 2004).

52. U.S. SECURITIES AND EXCHANGE COMMISSION, THE LAWS THAT GOVERN THE SECURITIES INDUSTRY, *available at* www.sec.gov/about/laws.stml (last visited Feb. 1, 2004).

THE EFFECT OF INTERNATIONAL ORGANIZATIONS ON CONVERGENCE

Global organizations are significantly impacting the convergence of core governance principles. Among these organizations are the International Corporate Governance Network, the Organization for Economic Cooperation and Development (OECD), the United Nations, the Export Import Bank, the International Organization of Securities Commissions, the American Society of Corporate Secretaries in cooperation with its sister organizations in other countries, the International Accounting Standards Board, the Institute of Internal Auditors, the Asia-Pacific Economic Forum, and the Asia-Pacific Economic Corporation. Seminars, conventions, publications, and meetings by and among these groups and their members have led to certain principles of corporate governance being generally identified as core principles that must guide the behavior of corporations in a market economy

There are several examples of international cooperation among various government agencies and membership organizations working toward corporate governance convergence. As a case in point, in 1999 the OECD adopted *Principles of Corporate Governance*.[53] These principles do not suggest that any one structure for companies' boards of directors is appropriate; different structures are appropriate in different circumstances for many of the reasons discussed in this section on factors affecting convergence. Similarly, in 1995, the International Corporate Governance Network was formed by a group of institutional investors, such as pension funds and financial institutions, to provide a forum for exchange on international corporate governance information.[54] It published guidelines in 1999 that have been relied on by many institutional investors in forming their own international corporate governance principles.[55] The International Organization of Securities Commissions has also released recent pronouncements on transparency and disclosure, auditor independence and the board's role in the oversight of outside auditors.[56] The International Accounting Standards Board and the United States Financial Accounting Standards Board are at work on global accounting standards; the accounting rulemaking bodies of other countries are also focused on implementing changes that would harmonize standards in their countries with accepted norms of international accounting.[57]

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53. Organisation for Economic Co-operation and Development (OECD) Ad-Hoc Task Force on Corporate Governance, *OECD Principles of Corporate Governance* (1999), *available at* http://www.oecd.org/dataoecd/47/50/4347646.pdf (last visited March 29, 2004).

54. *See* International Corporate Governance Network (ICGN), *ICGN History*, *at* http://www.icgn.org/history.html and ICGN, *ICGN Statement on Global Corporate Governance Principles* (July 9, 1999), *at* http://www.icgn.org/documents/globalcorpgov.htm, (last visited March 29, 2004).

55. *See* International Corporate Governance Network (ICGN), *ICGN Statement on Global Corporate Governance Principles* (July 9, 1999), *at* http://www.icgn.org/documents/globalcorpgov.htm (last visited March 29, 2004).

56. *See* International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, (May 2003), *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf (last visited March 29, 2004).

57. *See* Campos, *supra* note 49. In his speech Embracing International Business in the Post-Enron

THE EFFECT OF POLITICAL FACTORS ON CONVERGENCE

The stability of a country's government may also play a role in the development of corporate governance practices in particular countries. Where the government is relatively stable, the government may be able to legislate regarding issues in the corporate governance arena, whereas a less stable government's focus may simply be entrenchment.

Beyond the borders of a single country, the creation of certain international bodies such as the European Union (EU) is leading to convergence in the area of corporate governance practices, as well as in the area of commercial law. The EU has adopted a Financial Services Action Plan that addresses issues relating to corporate law, accounting and auditing, as well as access to the capital markets.[58] A focus on corporate governance principles is a very important part of the EU's goal

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Era, the SEC Commissioner stated:

> European officials and issuers for years have urged the SEC to accept financial state ments prepared under IAS without requiring reconciliation to US GAAP as required at present. SEC staff has noted two important considerations in assessing this requirement: progress in converging IAS and US GAAP and the development of an effective global financial reporting infrastructure for the consistent application, auditing and enforcement of IAS. Because investor protection is the fundamental mission of the SEC, we will look at the quality of the information received by US investors. The standards themselves are very important. No less critical is how standards are interpreted and applied in practice.
>
> With respect to convergence of IAS and US GAAP it is widely agreed that similar, high-quality answers to important accounting issues will benefit cross-border investors. Convergence of accounting standards should translate into greater transparency. This ultimately will increase the comparability of financial statements for investors and lower costs for cross-border issuers. As I mentioned earlier, the FASB and IASB entered into a memorandum of understanding to work together toward the important goal of convergence between US GAAP and IAS. The SEC has fully supported this project.
>
> While the FASB and IASB convergence project is still in its early stages, and involves many complicated issues, I continue to be encouraged by the progress being made. SEC staff is working closely with these organizations to support an agenda that prioritizes consistency among critical accounting standards.
>
> In addition to our work with the IASB and the FASB to encourage short-term convergence, we are working with regulators in other countries and with the accounting and auditing profession on ways to encourage the development of an effective global infrastructure for interpretation, auditing and enforcement of IAS. Such an infrastructure is as important as the accounting standards themselves. It is meant to ensure consistency and accountability. Without such mechanism, a "single" set of standards quickly could devolve, for practical purposes, into multiple standards. In this context, we are encouraged by the EU's work through CESR to develop a supporting infrastructure for IAS within the EU. We continue to see 2005 as an interesting possible target date for evaluating IAS.

*Id.*

58. *See* EUROPA, COMPANY LAW & CORPORATE GOVERNMENT, *available at* http://europa.eu.int/comm/internal_market/company/index_en.htm (last visited Jan. 21, 2004).

to create a single market for financial services in the EU.[59]

### THE EFFECT OF THE MEDIA ON CONVERGENCE

Pressure from the fourth estate is another factor leading to changes in the corporate governance arena. This pressure typically comes from a variety of media sources. There is a tremendous amount of business media coverage in today's climate. Talk show hosts interview executives, regulators and business commentators and articles are written about various companies and industries nearly every day. As a result of Enron, Worldcom and other high-profile frauds, much of the coverage has centered on issues of governance and the independence of directors. The media is now more attuned to issues of this ilk, and specific coverage of companies is likely to include coverage regarding governance practices. The value of the contribution of the media to the governance debate depends on the journalist's background; journalists who cover particular industries or companies gain insights and business acumen that a general journalist will not possess, making their coverage both more accurate and more insightful. Finally, there are a number of governance organizations that use media effectively to orchestrate a "name and shame" process. These organizations will publish "10 best" or "10 worst" lists in an attempt to draw attention to the accomplishments or failings of companies in the corporate governance arena.[60]

### THE EFFECT OF GOVERNMENT REGULATIONS ON CONVERGENCE

To some degree, United States government regulations on the subject of corporate governance have an extraterritorial effect, even where the effect was unintended. For example, Regulation FD,[61] which was passed by the Securities and Exchange Commission in August of 2000, is intended to level the playing field be-

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59. The EU has stated that:

> Harmonisation of the rules relating to company law and corporate governance, as well as to accounting and auditing, is essential for creating a Single Market for Financial Services and products. In the fields of company law and corporate governance, objectives include: providing equivalent protection for shareholders and other parties concerned with companies; ensuring freedom of establishment for companies throughout the EU; fostering efficiency and competitiveness of business; promoting cross-border co-operation between companies in different Member States; and stimulating discussions between Member States on the modernisation of company law and corporate governance.

*See id.*

60. E.g., Press Release, *The Corporate Library, Citigroup has the Highest Risk Board in the US According to the Corporate Library's New Rating of Corporate Directors*, (June 9, 2003) (on file with author), *at* http://www.thecorporatelibrary.net/products/ratings_press_release.html (last visited Jan. 28, 2004).

61. *See* U.S. Securities and Exchange Commission (SEC), *Final Rule: Selective Disclosure and Insider Trading*, Release Nos. 33-7881, 34-43154, IC-24599, 65 Fed. Reg. 51716 (Aug. 24, 2000), *at* http://www.sec.gov/rules/final/33-7881.htm (last visited March 29, 2004).

tween analysts, institutional investors and individual investors. The Commission believed that companies provided more information or earlier information to analysts and institutional investors than to individual investors.[62] Regulation FD requires that companies communicate material information contemporaneously to these groups.[63] As companies from other countries court American investors, they must be aware of the requirements of Regulation FD. Similarly, as American companies deal with investors abroad, those companies will act as they have been trained to act by their United States-based attorneys.

The Sarbanes-Oxley Act[64] also has an extraterritorial effect. Section 906 of the Act,[65] which is the officer certification provision to which criminal penalties attach, applies to periodic reports containing financial statements. This would cover not only Forms 10-K and 10-Q filed by United States issuers, but also Forms 20-F 40-F[66] and 6-K filed by foreign issuers.[67]

Ethiopis Tafara, the Director of the SEC's Office of International Affairs, acknowledged in a speech that SEC actions have caused concerns in the international community.[68] The concerns include: (i) the required registration and inspection of foreign audit firms, which are covered by the Public Company Accounting Oversight Board's[69] (PCAOB) broad-ranging authority to regulate auditing firms; (ii) the potential violation of privacy laws, which are extremely strict in the European Union and require that companies transmitting personal data take a number of precautions; and (iii) whether the PCAOB's inspection rights, which would give it broad powers to require that foreign audit firms produce work papers relating to their audits, are too broad.[70] The PCAOB will work in a cooperative manner with accounting regulators from other countries to reach a consensus on these matters.[71]

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62. *See* Michael P Daly & Robert A. Del Giorno, *The SEC's New Regulation FD: A Critical Analysis*, ST. JOHN'S J. LEGAL COMMENTARY 461-462 (2002).

63. *Id.* at 463.

64. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745, 15 U.S.C. 7201 et seq. (2002).

65. 18 U.S.C. §1350(c) (2002).

66. This form is specific to Canadian issuers. *See* U.S. Securities and Exchange Commission (SEC), *Securities and Exchange Commission Forms List, at* http://www.sec.gov/about/forms/secforms.htm.

67 The SEC amended Forms 20-F and 40-F to include certifications by the officers. *See SEC, Final Rule: Certification of Disclosure in Companies Quarterly and Annual Reports*, Release Nos. 33-8124, 34-49427 IC-25722 (Aug. 29, 2002), at http://www.sec.gov/rules/final/33-8124.htm (last visited March 29, 2004).

68. Ethiopis Tafara, *U.S. Perspective on Accountancy Regulation and Reforms*, Remarks at the Annual Conference of the Institute of Chartered Accountants in England & Wales, (July 8, 2003), *at* http://www.sec.gov/news/speech/spch070803et.htm (last visited March 29, 2004) [hereinafter Tafara].

69. *See generally* Public Company Accounting Oversight Board, *at* http://www.pcaobus.org/ (last visited February 28, 2004).

70. *See* Tafara, *supra* note 68.

71. "Although the PCAOB's final rules call for registration of non-US firms by April 2004, the PCAOB hopes, before that time, to be able to make substantial progress with its foreign colleagues in developing harmonized registration and oversight models. *Id. See also* Campos, *supra* note 49 (noting that the SEC and the PCAOB have made a number of accommodations to foreign firms, including: not requiring foreign audit firms to provide registration information to the PCAOB if it would violate

Fortunately, the SEC has a long history of cooperation with regulators in other countries. Over the years, many different mechanisms have developed to allow for the regulators of various nations to work together on matters affecting their countries. These include memoranda of understanding between the SEC and its counterparts, as well as arrangements for the sharing of information among regulators and law enforcement agencies around the world.

## GOVERNANCE CHANGES IN PARTICULAR MARKETS

All of the factors discussed above have had an effect on the convergence – and speed of convergence – of core corporate governance principles. The section which follows provides an overview of the status of governance in Canada, Germany, Japan, Mexico and the United Kingdom, the similarities to governance laws in the United States, and any recent changes in governance in that market.

### *CANADA*

According to an assistant secretary with a Canadian oil company, in Canada "the bad news is that everything is changing. On the other hand, the good news is that everything is changing."[72] The changes in corporate governance in the United States have had a profound effect in Canada as well. Canada's primary securities regulator is moving to a United States-style, rules-based corporate governance regime.

One factor that significantly impacts securities regulation in Canada is the lack of a single, national agency regulating securities. Instead, there are thirteen provincial and territorial agencies responsible for the regulation of securities in Canada.[73] The Ontario Securities Commission, because the Toronto Stock Exchange is located within its jurisdiction, wields more power than the other regulators in Canada.

Corporate governance issues are complicated in Canada by the lack of harmonization among the various provinces, and by bickering amongst the various provincial securities regulators. In British Columbia and Alberta, for example, regulators favor a principles-based regulatory scheme, while in Ontario, regulators favor a rules-based scheme patterned after new United States laws, such as the Sarbanes-Oxley Act.

It has been nine years since the Toronto Stock Exchange (TSX) first introduced corporate governance disclosure regulations in response to the Dey report.[74]

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the laws of their home country, granting foreign audit firms an additional six months during which to register; and limiting the registration only to those who provide more than ten hours of work on the audit).

72. Sylvia Groves, Assistant Corporate Secretary with Nexen, (quoted in *Keeping Up*, CORP SECRETARY 22 (Aug.-Sept. 2003).

73. *See* Canadian Securities Administrators (CSA/ACVM), *About the CSA* (June 2001), *at* http://www.csa-acvm.ca/html_CSA/about_who_are_csa.html (last visited March 29, 2004).

74. The report is so named because Peter Dey chaired The Toronto Stock Exchange Committee on

The TSX listing standards that were passed in 1994: (i) clearly identified the role of directors as stewards of the corporation; (ii) required that the board have a majority of "unrelated directors;"[75] (iii) noted that the board should review the adequacy and form of compensation of directors; (iv) required that certain board committees be comprised of outside directors, a majority of whom are unrelated directors; (v) required the audit committee to be comprised solely of outside direc tors; and (vi) required that each company disclose on an annual basis its governance process with respect to the guidelines.

In 2002, the TSX proposed new governance standards.[76] These new standards require, for example, that boards oversee the company's strategic planning process; that all members of the audit committee be financially literate,[77] with at least one member having "accounting or related financial expertise,"[78] and that the audit committee have a charter [79] The new changes would also slightly tweak the definition of "independent directors, defining these individuals as directors "free from any other relationship which could reasonably be perceived to materially interfere with the director's ability to act with a view to the best interests of the issuer."[80] The TSX also went on record as supporting stricter standards such as CEO and CFO certification of the financial statement, but is deferring to legislators on this issue.[81] Following the TSX's guidance, Canadian securities regulators are proposing certification rules similar to the requirements under the Sarbanes-Oxley Act

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Corporate Governance which released its report, "Where Were the Directors?" in December of 1994. *See Guidelines for Improved Corporate Governance*, *at* http://www.ecgi.org/codes/country_documents/canada/dey.pdf (last visited Feb. 3, 2004).

75. An "unrelated director" was defined by the TSE as one who is independent of management and free from any interest and any business or other relationship which could materially interfere with the director's ability to act with a view to the best interests of the corporation. *See* David Armstrong, Corporate Governance in Canada (October 25, 2002), *at* http://www.ffhsj.com/Symposium_Material/GC_fall_02/corp_gov_canada.pdf (last visited March 29, 2004) [hereinafter Armstrong].

76. *See id. See also* Toronto Stock Exchange, Corporate Governance Policy–Proposed New Disclosure Requirement and Amended Guidelines (March 26, 2002), *at* http://www.ecgi.org/codes/country_documents/canada/policy_draft_26mar2002.pdf [hereinafter *TSX Corporate Governance Policy*] (last visited March 29, 2004).

77 Financially literate was defined by the TSE as the ability to read and understand financial statements of complexity and scope similar to the issuer's financial statements. *See* Armstrong, *supra* note 75, at 7.

78. Financial expertise is the ability to understand the issuer's financial statements and the generally accepted accounting principles used to prepare those statements; an ability to asses the application of GAAP with respect to accruals, reserves and estimates; experience, either directly or through supervising others, in preparing or auditing financials in situation that would raise issues similar to the issues the issuer faces; an understanding of internal controls; and knowledge of the audit committee's role.

As in the United States, there is concern that the person designated as the financial expert on the audit committee could be held to higher standard of care than other directors or face liabilities that exceed those of other directors. The CSA did not include a specific safe harbor for the person designated as the "financial expert. Rather, the CSA has stated that the designation will not increase that directors' personal liability. *Id.*

79. *See TSX Corporate Governance Policy*, *supra* note 76.

80. *Id.*

81. *Id.*

that chief executive officers and chief financial officers certify the accuracy of their company's financial reporting.[82]

The Chairman of the Ontario Securities Commission asked that the Canadian Institute of Chartered Accountants address issues of auditor independence, rotation of engagement partners, and possibly rotation of the firm.[83] The Chairman also asked that the Law Society of Upper Canada consider whether to implement Sarbanes-Oxley type rules governing professional conduct before the Ontario Securities Commission and whistle-blowing by outside counsel.[84] On June 27 2003, the Canadian Securities Administrators released proposed rules on governance issues for public comment.[85] The rules cover audit committees,[86] officer certifications and auditor independence.[87] The Proposed Rules follow the U.S. initiative of a rules-based approach to corporate governance as opposed to the traditional Canadian principles-based approach. Subsequently, the efforts of the Canadian Securi-

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82. 18 U.S.C. 1350 (a), (b). (Sarbanes-Oxley Act of 2002). Section 302 of the Sarbanes-Oxley Act required the SEC to adopt rules requiring certification of the quarterly and annual periodic reports filed with it. The SEC adopted Rules 13a-14 and 15d-14 under the Exchange Act. The chief executive officer and chief financial officer must now certify that they have reviewed the report, that to their knowledge the report contains no false or misleading statements and does not omit any material facts, the financial statements fairly present in all material respects the company's results of operations and cash flows for the reporting period, that the signing officers are responsible for internal controls of the issuer and have evaluated those controls within the prior ninety days, that they have disclosed to the audit committee and outside auditors any significant deficiencies in controls and any fraud involving management or employees having significant role in internal controls, and whether any factors could significantly affect internal controls after the evaluation date. The format for this report is prescribed in the SEC's release, and may not be altered.

A similar certification provision is contained in Section 906 of the Sarbanes-Oxley Act. This provision, which has criminal implications, requires that the chief executive officer and chief financial officer certify that the periodic report fully complies with the requirements of the Exchange Act. Section 906(a) and (b) of the Sarbanes-Oxley Act, 18 U.S.C. 1350(a), (b). False certifications can result in penalties of up to a $1 million fine, imprisonment for up to ten years, or both, for non-willful violations and a $5 million fine, imprisonment for up to twenty years, or both, for willful violations. H.R. 3763, 107th Cong. (2d Sess. 2002).

83. Presently under Canadian corporate law, the shareholders select the auditors annually and set the auditors' compensation. *Canada Business Corporations Act*, §162. The approach suggested would differ significantly from the existing approach. *See* Armstrong, *supra* note 75, at 8.

84. *See* Armstrong, *supra* note 75, at 8.

85. *See* OSC, Notice of Request for Comments (June 27, 2003), *at* http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/rule_52-108_20030627_c1notice-roc.pdf (last visited March 29, 2004).

86. With respect to audit committees, the proposed rules are in many ways similar to the audit committee requirements under the NYSE Listing Standards. For example, the audit committee must have written charter. It must recommend the outside auditors and their fees to the full board, oversee the work of the outside auditors, pre-approve non-audit services above a de minimis threshold, review filings and press releases, review hiring of external auditors or former external auditors as employees, oversee the issuer's disclosure processes, and establish complaint procedures. *See* OSCB, Multilateral Instrument 52-108, *Auditor Oversight*, *at* http://www.conferenceboard.ca/GCSR/links/pdfs/OSC_Auditor_Oversight_Jun03.pdf; OSCB, Multilateral Instrument 52-109, *Certification of Disclosure in Companies Annual and Interim Filings*, *at* http://www.conferenceboard.ca/GCSR/links/pdfs/OSC_Certification_Jun03.pdf; OSCB, Multilateral Instrument 52-110, *Audit Committees*, *at* http://www.conferenceboard.ca/GCSR/links/pdfs/OSC_Audit_Committees_Jun03.pdf (last visited March 29, 2004).

87 *See id.*

ties Administrators to lead governance reform in Canada have slowed as regulators from the various jurisdictions have differing views about approaches to reform.[88] If adopted "as is" the rules will become effective next year.

Ontario's government passed several new laws in late 2002 that strengthen governance in Canada.[89] These include increasing fines from $1 million (Canadian) to $5 million (Canadian),[90] increasing prison terms from two years to one day less than five years,[91] increasing fines for insider trading to the greater of $5 million (Canadian) or triple the profit made,[92] strengthening the laws prohibiting market manipulation and fraud,[93] and giving the Ontario Securities Commission new rulemaking authority.[94] This new rulemaking authority empowered the Ontario Securities Commission to require that CEOs and CFOs certify that the financial statements fairly present the issuer's financial condition. Further, certifications regarding internal controls and procedures will be required on filings made after January 1, 2004.[95]

The most recent change is the Ontario Securities Commission's release for comment of a Proposed Policy regarding corporate governance practices.[96] The proposals are being considered by the securities regulators of each province other than British Columbia and Quebec.[97] The OSC requested that comments be provided by April 15, 2004.[98] Among the governance proposals recommended by the OSC are that a majority of board members should be independent and that those directors should meet regularly The chair should be an independent director or a

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88. *See* Karen Howlett, *BCSC Head Accuses OSC Boss of Raising Fears Over Reform* (Aug. 27 2003), *at* http://regulators.itgo.com/PI/369.htm (last visited March 29, 2004). The article states that "British Columbia Securities Commission chairman Douglas Hyndman has accused his counterpart in Ontario of raising false alarms about his proposed securities reforms, marking the latest volley in an escalating war of words between the two provincial watchdogs. *Id.* The article further notes that, due to the "widening rift, Hyndman has stepped down from his position as head of the Canadian Securities Administrators, hamstringing the efforts of a group that should play a leading role in governance reforms in Canada. *Id.*

89. *See* Armstrong, *supra* note 75, at 13.

90. *Id.*

91. *Id.*

92. *Id.*

93. *Id.*

94. *Id.*

95. *See* OSCB, Multilateral Instrument 52-109, Certification *of Disclosure in Companies Annual and Interim Filings, at* http://www.conferenceboard.ca/GCSR/links/pdfs/OSC_Certification_Jun03.pdf

96. Ontario Securities Commission, News Release, "Regulators Propose Corporate Governance Reforms for Issuers, (January 16, 2004), *at* http://www.osc.gov.on.ca.en/About/News/NewsReleases/2004/nr_20040116_osc-corporate.htm> (last visited April, 29, 2004); and Ontario Securities Commission, Proposed and Final Rules, "Request for Comment: Notice on Proposed Multilateral Policy 58-201 Effective Corporate Governance, and Proposed Multilateral Instrument 58-101 Disclosure of Corporate Governance Practices, Form 58-101F1 and 101F2 (January 16, 2004), *at* http://osc.gov.on.ca/en/Rulemaking/Policies/pol_20040116_58-201_roc.htm.

97. *See* http://library.lsuc.on.ca/GL/stay_informed_corporate.htm. Both the British Columbia and Quebec Securities Commissioners plan to publish their own corporate governance guidelines in the near future.

98. *See TSX Guidelines for Improved Corporate Governance, supra* note 76.

lead director who is independent should be appointed. A written corporate governance policy should be adoped by the board and this policy should describe the positions of the directors and CEO. Training and director education opportunities should be provided to the board members. A code of ethics should be adopted. The board should create a compensation committee and also a nominating committee that will adopt policies regarding the criteria for selection of new directors. The board will develop assessment tools to review the performance of the entire board, as well as the performance of individual directors. Each of the proposals is written in precatory language, giving issuers the ability to exercise a substantial amount of discretion in deciding how best to apply the practices to its own business.

Once adopted, the TSX's new corporate governance standards would be revoked to the extent they are inconsistent with, or create duplication or regulatory overlap with, the OSC corporate governance standards.[99] These suggested changes by the OSC would bring Canada's listed companies more in line with the governance expected of public companies in the United States. Many of the suggested changes, such as the creation of nominating and compensation committees, are changes that the NYSE already requires of listed companies. Similarly, the direc tor education and assessment tools are similar to recent changes in the United States.

*GERMANY*

As noted previously, boards of directors of public companies in Germany have two levels – the *Vorstand*, which is a management board, and the *Aufsichtsrat*, which is a supervisory board comprised of outside directors.[100] These are separate groups of people, such that members of the *Vorstand* who serve as members of the company's executive committee are not members of the *Aufsichtsrat*. Further, the *Aufsichtsrat* cannot exercise managerial powers to avoid circumvention of the required two-tier structure.

In the United States, there is a definite trend toward the appointment of a majority of outside directors; in Germany however, the two-tiered structure has for years required independent, outside directors at the highest level. These directors represent both capital and labor. They are appointed by the shareholders at the annual meeting and also by the trade unions; employees appoint directors to the board in furtherance of the system of labor co-determination in Germany [101]

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99. *See generally* http://library.lsuc.on.ca/GL/stay_informed_corporate.htm.

100. *See* Thomas Marx, *Doing Business in Germany* (August 2001), *at* http://www.legamedia.net/legapractice/marx_thomas/2001/01-08/0108_marx_thomas_business-germany_01.php (last visited March 29 2004).

101. Section 102(1) AktG. Different compositions of the board are required under German law, depending on the number of employees a company has. Under the German Shop Constitution Act, a company with more than 500 but less than 2,000 employees must have one-third of the Aufsichtsrat members represent employees. If the company has more employees, the German Co-Determination Act requires that one-half of the Aufsichtsrat members represent employees. *See* Dr. Theodor Baums, *Cor-*

This two-tiered structure has received criticism over the years. Some say that the major banks in Germany exercise too much power and that just a few banks may have seats on the boards of several major companies, leading to interlocking directorates.[102] A conflict of interest could arise from service on the boards of competing companies, but this is addressed through the disclosure of the board members' other positions. Another concern is that the appointment of a labor representative to the board could lead to a fragmented board, with labor and management factions meeting separately with the chairman and meetings being little more than perfunctory gatherings aimed at avoiding unpleasant discussions. The two-tiered structure may also have an unintended effect of limiting the amount of information provided to the board. Attempts to avoid providing certain information to the labor representative on the board may mean that the board would not receive information that, in the United States, a board of directors would receive. One final criticism that has been leveled against the two-tiered board structure is that the structure breeds inefficiencies. While this may be true to some degree, in many respects the *Vorstand* is essentially the same as a United States company's executive committee.

Like Canada's corporate governance code, Germany has a "comply or disclose" corporate governance regime. In July of 2002, Germany enacted the Transparency and Publicity Act ("TransPuG"),[103] an act based on recommendations made by the German Corporate Governance Commission, whose Corporate Governance Code was first published in February of 2002.[104] TransPuG became effec tive on January 1, 2003. The Act covers disclosure, transparency and accounting issues.[105] Because TransPuG is so new, German courts have not yet addressed the question of whether violation of the Corporate Governance Code creates any liability for the company, but the courts may see compliance with the Code as creating a safe harbor for corporations.[106]

On an annual basis, the *Vorstand* must now file a Compliance and Disclosure Statement with the *Handelsregister* or Commercial Register.[107] That Compliance and Disclosure Statement is a representation both as to compliance during the year and compliance at the time of filing with the principles in the Corporate Govern-

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*porate Governance Systems in Europe – Differences and Tendencies of Convergence*, Crafoord Lecture, *at* http://www.jura.uos.de/institut/hwr/PDF/a0896.pdf (last visited March 29, 2004).

102. *See* Richard Deeg, *German Banks and Industrial Finance in the 1990'* (October 1996), *at* http://skylla.wz-berlin.de/pdf/1996/i96-323.pdf (last visited March 29, 2004).

103. *See* Commission of the German Corporate Governance Code, *Transparency and Disclosure Law Now in Force* (July 30, 2002), *available at* http://www.corporate-governance code.de/eng/news/transparenzgesetz20020801.html (last visited March 29, 2004) [hereinafter *Transparency and Disclosure*].

104. *See* Commission of the German Corporate Governance Code, *German Corporate Governance Code*, *available at* http://www.corporate-governance-code.de/index-e.html (last visited Feb. 4, 2004).

105. *Id.*

106. Hassan Sohbi, *TransPuG. The Impact of Comply and Explain Regulation*, Speech at 2nd Annual German Investor Relations Conference (Dec. 5, 2002), *available at* http://www.osborneclarke.com/publications/pdf/transpug.pdf (last visited Feb. 4, 2004).

107 *See Transparency and Disclosure*, *supra* note 103.

ance Code.[108] If the company has failed to comply with certain provisions of the German Corporate Governance Code, the company must specifically disclose those provisions with which it failed to comply.[109] Certain provisions of the Corporate Governance Code restate mandatory provisions from German corporate law, while other provisions are precatory and simply give guidance as to best practices.[110] Among the precatory provisions are that no more than two members of the *Aufsichtsrat* may be former *Vorstand* members, *Aufsichtsrat* members may not serve on competitors' boards, conflicts of interest must be disclosed, committees shall be formed to perform certain tasks, and audit committee members must be independent.[111]

*JAPAN*

Commodore Perry's black ship has become a metaphor in Japan for that country's westernization.[112] Recent changes in the corporate governance arena in Japan are further evidence of the country's continuing westernization.[113] Despite the attempts to change, Japan is still viewed as lacking in the transparency and disclosure rules necessary to provide a high level of investor confidence.[114] Japan started to transform governance practices slowly: in 2000, the Tokyo Stock Exchange wrote to all companies listed upon it and requested that they revise their corporate governance practices to take into account shareholder interests to a greater degree.[115] The Tokyo Stock Exchange also established a permanent corporate governance committee to advise the Exchange and listed companies.[116] Today, how-

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108. *Id.*

109. *Id.*

110. *See* Government Commission, *German Corporate Governance Code* (May 21, 2003), *available at* http://www.corporate-governance-code.de/eng/download/DCG_K_E200305.pdf (last visited March 29, 2004).

111. *Id.*

112. *See* Naval Historical Center, *Commodore Perry and the Opening of Japan: Background*, (Nov. 25 2002), *available at* http://www.history.navy.mil/branches/teach/ends/opening.htm [last visited March 29, 2004].

113. The United States has been charged with exporting poor corporate governance practices. *See generally* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY: AMERICA'S NEWEST EXPORT (Yale University Press 2001). Recent changes in governance in Japan, as discussed in this section, make it clear that current thinking in Japan with respect to governance is tracking more closely than ever the United States' approach to governance.

114. *See* Standard & Poor's, *Japan Corporate Governance in Transition: Weaknesses Remain and Challenges Continue* (2002) and *An Overview of Corporate Governance in Japan* (2002). *See also* Michael Solomon Associates, Inc., Interview with Ted White, Director of Corporate Governance, CalPERS, 4 Japan Corporate Governance Report, 2 (Jan. 2003), *available at* http://www.msapr.com/pdf/JCGReport_Jan03_English.pdf (last visited March 29, 2004), in which he states, .Japan needs to strengthen the independence of their boards, improve their disclosure and transparency, pay particular attention to the independence of company auditors, and increase their communication with shareholders.

115. Michael Solomon Associates, Inc., Interview with Takuski Shimoda, Managing Director of the Tokyo Stock Exchange, 5 Japan Corporate Governance Report 2 (March/April 2003), *available at* http://www.msapr.com/pdf/JCGReport_Apr03_English.pdf (last visited March 29, 2004).

116. *Id.*

ever, less than thirty percent of companies listed on the Tokyo Stock Exchange have independent directors.[117]

There may well be cultural reasons for the slow pace of change in the corporate governance area. Corporations in Japan focus on the importance of consensus in decision making. Further, the concept of "family" is extremely important in the Japanese capital market. Due to cross shareholdings, there are interrelationships among many companies in Japan. These *keiretsus* are tied together through a common ownership structure which may, in many instances, involve the primary bank for one or more of the related companies. This ownership structure results in shareholders – even large shareholders – being fairly stable and passive. Despite a substantial shareholding, these shareholders may not exert control in the same ways as might major shareholders in the United States. Another unusual factor in Japan that affects the area of corporate governance has been the lack of hostile takeovers. Unlike other markets where there may be bidding wars or hostile takeovers, the Japanese focus on consensus will not motivate companies to "window dress" for a potential bidding war. Finally, the Japanese government plays a strong role in corporate governance, as the government has shown willingness to intervene to assist troubled companies.

On May 22, 2002, the Diet passed revisions to Japan's Commercial Code.[118] The revisions, effective April 1, 2003, included a number of changes affecting the operation of boards of directors in Japan. The boards of large companies, those most likely to be recipients of foreign investment, are now allowed to either operate using a single tier structure like boards of directors in the United States or maintain their traditional Japanese style structure.[119] Those opting for the new system must establish three committees of the board of directors: a nomination committee, an audit committee and a compensation committee.[120] A majority of the members of each of the three committees must be an outside director. The role of each committee is similar to the role that committee would serve in a United States company. Since the passage by the Diet of the laws allowing creation of American-style board committees, several companies in Japan have announced, or are considering announcing, plans to reorganize their boards of directors.[121]

In addition to the recent revisions to the Commercial Code allowing Japanese companies to operate using American-style boards of directors, Japan is also fol-

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117 *Id.* Not only do few companies in Japan have independent directors, others simply do not see the need for independent directors. For example, Toyota restructured its board in early 2003 to reduce the number of directors from fifty-eight to twenty-seven. It did not before the restructuring, and still does not, have any independent directors on the board. *Id.* at 4.

118. Ryoko Ueda, *Corporate Governance and Reform of Japan Commercial Code*, 2 J-IRIS Research Newsletter 1 (Oct. 2002), *available at* http://www.j-iris.com/newsletter/nl02.pdf (last visited March 29, 2004).

119 *Id.* at 2.

120. *Id.*

121. These include Sony, Orix, Hitachi, Toshiba, Minolta, Konica, and the Aeon Group, among others. JETRO, *Focus: Economic Revitalization—Corporations and Investors Position Themselves to Compete in the New Japan*, (Mar. 19, 2003), *at* http://www.jetro.go.jp/usa/newyork/focusnewsleter/focus21.html (last visited March 29, 2004).

lowing the lead of the United States in crafting reforms in the accounting and auditing areas. Japan's Financial Services Agency's Subcommittee on Certified Public Accountant Regulation has recommended taking steps to enhance auditor inde pendence, such as limiting non-audit services and rotating audit staff, as well as working to increase the number of accountants in Japan.[122] Stronger government of the accounting industry is also among the proposed reforms.[123]

*MEXICO*

The tenor of the corporate governance debate in Mexico is very different than in the United States. In the United States, the debate deals mainly with creation of the proper balance between the shareholders and the management of companies. In Mexico, the debate—while not overlooking the former issue – deals more with the relationship between majority and minority shareholders.[124] In both versions of the debate on governance, the overriding issue is one of balancing competing interests.

Although there are several different forms of commercial entities in Mexico, all companies listed on the *Bolsa Mexicana de Valores* are organized as limited liability stock corporations having the *sociedad anonima* designation. The general law of corporations is the *Ley General de Sociedades Mercantiles*,[125] while the *Ley del Mercado de Valores*, or Securities Act, is that country's securities law.[126] As provided in these laws, companies are overseen by the board of directors, but in

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122. Michael Solomon Associates, Inc., *Regulatory Watch: A Blueprint for Accounting Reform in Japan: Blue-Ribbon Panel Releases Its Recommendations to the Financial Services Agency*, 4 Japan Corporate Governance Report 3 (January 2003), *at* http://www.msapr.com/pdf/JCGReport_Jan03_English.pdf (last visited March 29, 2004). There are 14,000 CPAs in Japan currently; the report targets having 50,000 CPAs in Japan by the year 2018. *Id.*

123. *Id.*

124. New rules to protect the interests of minority shareholders are contained in the Securities Act, Article 14 Bis 3, sections III and IV The new rules were enacted on June 1, 2001, but became effective the following year in conjunction with the date of the annual meeting for companies affected by the rules. The rules provide, among other things, that:

1. Minority shareholders have the right to appoint at least one member of the board of directors for each ten percent of stock ownership;
2. Minority shareholders who hold at least ten percent of the shares have the right to appoint one comisario, or statutory auditor;
3. Minority shareholders who hold at least ten percent of the shares have the right to cause a shareholders meeting to be postponed for at least three days if they have not received sufficient information about the matters to be voted upon;
4. Minority shareholders who hold at least ten percent of the shares have the right to request that a shareholders meeting be called;
5. Minority shareholders who hold at least fifteen percent of the shares have right to file a civil action against the board of directors; and
6. Minority shareholders who hold at least twenty percent of the shares have the right to oppose shareholder resolutions that have been passed.

125. Carlos Creel C & Alfonso Garcia-Mingo, *Corporate Governance under Mexican Law*, INT'L FIN. L. REV., in THE IFLR GUIDE TO MEXICO 43 (Ben Maiden ed., 2001) [hereinafter Creel C & Garcia Mingo].

126. *Id.* at 43.

addition to the board of directors, the company must have a *comisario,* or statutory auditor who has an obligation to oversee operations of the company and deliver an annual report.[127] Generally, these individuals are the partners of the company's outside auditing firm.

On June 9 1999, a new *Codigo de Mejores Pacticas Corporativas*, or Best Practices for Corporate Governance for Mexico, was introduced.[128] The Code had been drafted through the cooperation of the Mexican Bankers' Association, the Mexican Institute of Finance Executives, the Mexican Institute of Public Accountants, and the *Bolsa Mexicana de Valores*, Mexico's stock exchange.[129] The Code addresses governance issues relating to the structure and function of boards of directors,[130] auditing of the company and oversight of internal controls,[131] and finance, planning, transparency and disclosure in the provision of relevant information to shareholders.[132] Compliance with the Code is voluntary· Mexico has followed a principles-based rather than rules-based approach to governance.[133] Companies must file a report annually with the *Bolsa* identifying any areas of the Code with which they are non-compliant and explaining the reasons for the non-compliance.[134]

Like the United States, Mexico has a single government agency responsible for the oversight of the country's capital markets. The *Comision Nacional Bancaria y de Valores,* or National Banking and Securities Commission, oversees the

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127 Antonio Franck C, Rafael Robles Miaja, & Manuel Galicia R, *Amendments to the Mexican Securities Law*, INT'L FIN. L. REV., in THE IFLR GUIDE TO MEXICO 83, 90 (Ben Maiden ed., 2001).

128. Bolsa Mexicana de Valores, *Corporate Governance Code for Mexico* 1, at http://www.ecgi.org/codes/country_documents/mexico/mexico_code_en.pdf (Sep. 26, 2002) (last visited March 29, 2004) [hereinafter Mexico Code].

129. *Id.*

130. *Id.* at 2. Section 1 of the Code explains that day-to-day operations are the responsibility of management, while the board of directors is to provide strategic oversight. *Id.* Section 1.2 deals with the number of directors, discourages the use of alternate directors, requires that the board include outside directors, and suggests the information to be provided to shareholders to enable them to vote on the slate of proposed directors. *Id.* Section 1.3 deals with the structure of the board and recommends the use of audit, compensation and finance and planning committees. *Id.*

131. *See* Section 3.2 of the Corporate Governance Code for Mexico in Mexico Code, *supra* note 128, at 2.

132. *See* Sections 5.1 and 5.2 of the Corporate Governance Code for Mexico, in Mexico Code, *supra* note 128, at 2. Until recently, it was not the common practice in Mexico for companies to send lengthy proxy statements containing information about the director nominees and other issues; rather, the primary communication tool with shareholders was the company's annual report, which is required by Article 14 of the Ley Del Mercado de Valores (the Securities Act of Mexico). There is still great reluctance, due to security concerns, for companies in Mexico to provide the type of disclosure regarding executive compensation that shareholders in the United States are accustomed to receiving. Rather, if companies do make executive compensation disclosures, they do so by aggregating the compensation information rather than by providing detailed information about specific executives. They may also discuss the general compensation philosophy of the company in the disclosure materials.

133. Bryan W Husted & Carlos Serrano, Corporate Governance in Mexico 15-16, *at* http://egade.sistema.itesm.mx/investigacion/documentos/documentos/9egade_husted.pdf (May 2001) (last visited March 29, 2004).

134. *Id.* at 15.

registration of securities and regulates issuers.[135] The Securities Act sets forth general communications requirements, such as the requirement that a company provide an annual report to shareholders.[136] The company's audit committee must, at the annual shareholders meeting, give a report to shareholders.[137] The Act also defines independent directors and requires that the chair and a majority of the members of the audit committee be independent.[138] Most Mexican companies have only recently begun to establish audit committees and draft charters for those committees; in many instances, they follow the charters used by United States companies as models.

*UNITED KINGDOM*

It is the United Kingdom which produced the Cadbury Report, one of the first extensive reviews of governance practices.[139] Over the years, a number of other reports issued in the UK have provided further thought on governance practices. These include the Greenbury Report,[140] which focused on disclosure of director pay· the Hampel Report[141] issued in June of 1998, which became the Combined Code and is discussed below; the Turnbull Report,[142] issued in September of 1999 which reviewed companies' approach to internal controls; and most recently the

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135. *Id.*

136. Creel C & Garcia-Mingo, *supra* note 125, at 44.

137 *Id.* at 46. Securities Act, Section 14 Bis 3, subsections IV and V as amended.

138. Franck C, *supra* note 127, at 86.

Securities Act, Article 14, states that the following will not be deemed independent directors:

1. Employees or managers of the company, or persons employed by the company during the prior year;
2. Significant shareholders who, although they are not employed by the company, wield management power;
3. Affiliates of groups providing consulting services to the issuer if the transaction with the issuer represents ten percent or more of that firm's revenues;
4. Customers, suppliers, debtors, creditors, partners, directors or employees of other entities having an important relationship with the issuer;
5. Employees of charitable institutions that receive significant contributions from the issuer, defined as more than fifteen percent of the grants received by the institution;
6. Senior executives of other companies, where senior executive of the issuer serves on the other company's board; and
7. Spouses and other close relatives of those listed above.

139. The Committee on the Financial Aspects of Corporate Governance & Gee and Co. Ltd, *Report of the Committee on the Financial Aspects of Corporate Governance* (Gee 1992), *at* http://www.ecgi.org/codes/country_documents/uk/cadbury.pdf (last visited March 29, 2004).

140. *See Greenbury Recommendations*, at http://www.blindtiger.co.uk/IIA/uploads/2c9103-ea9f7e9fbe—7e22/Greenburyreport.pdf (last visited Feb. 9, 2004).

141. *See* G. P Stapledon, *The Hampel Report on Corporate Governance*, 16 COMPANY AND SECURITIES L. J. 408, 408-413 (1998), *available at* http://www.corpgov.com/publications /fulltext/hampelreport.pdf (last visited Feb. 9, 2004).

142. *See* THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES, INTERNAL CONTROL. GUIDANCE FOR DIRECTORS ON THE COMBINED CODE (Accountancy Books 1999), *available at* http://www.ecgi.org/codes/country_documents/uk/turnbul.pdf (last visited March 29, 2004).

Higgs Report,[143] issued in January of 2003.

The issuance of the Higgs Report, commissioned by the Department of Trade and Industry, builds upon the corporate governance foundation laid in the Cadbury report. Some criticized the report, however, as an attempt to go too far in regulating corporations.[144] The concern appears to be that the UK, if not cautious in adopting governance reforms, will be carried along with the reforms in the United States and other countries in adopting a rules-based approach rather than the principles-based approach, which has been the hallmark of governance in the UK.

Primary laws governing UK corporations are the Companies Act of 1985,[145] the City Code on Takeovers and Mergers,[146] the rules applicable to mergers adopted by the Takeover Panel,[147] and the Financial Services Authority's Code of Market Conduct.[148] In addition, the Combined Code on Corporate Governance, as supplemented by the Turnbull Report, applies to all listed companies in the UK, including those listed on the London Stock Exchange.[149] As in Mexico, compliance with the Code is voluntary [150] If companies choose not to comply with the Code, they must disclose the non-compliance in their annual report and state the reasons for the non-compliance.[151]

The Combined Code requires that non-executive directors comprise at least one half of the directors.[152] A majority of these non-executive directors should also be free from any relationship with the company or management that would

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143. DEREK HIGGS, REVIEW OF THE ROLE AND EFFECTIVENESS OF NON-EXECUTIVE DIRECTORS (Jan. 2003), *available at* http://www.dti.gov.uk/cld/non_exec_review/pdfs/higgsreport.pdf (last visited March 29, 2004).

144. *See* Alexandra Johnson, *Kelley Rejects Higgs Criticism as 'Disturbing Complacency* ACCOUNTANCYAGE.COM, (March 12, 2003), *at* http://www.accountancyage.com/News/1132858 (last visited March 29, 2004). The article refers to a speech given by Ruth Kelly, financial secretary to Treasury, in which she defends the Higgs Report. The Higgs Report had been criticized in the UK as rule-book and a step too far toward the US-style rules-based approach to corporate governance. *Id. See also* David Rae, *Former Dixons Chairman Slams Higgs*, ACCOUNTANCYAGE.COM, (March 5, 2003), *at* http://www.accountancyage.com/News/1132772 (last visited March 29, 2004).

145. HALSBURY'S STATUTES OF ENGLAND AND WALES 88, (Andrew Davies, Gilian Bailey, & Eric Roydhouse, eds., Butterworths (1999)).

146. The City Code on Takeovers and Mergers, which was last revised and reissued in July 2000, is similar to the Williams Act of 1968, which amended the Securities and Exchange Act of 1934. The City Code provides for equal treatment of shareholders, disclosure to shareholders, and good faith consideration by the board of offers and prevents market manipulation.

147 CHARLES M. NATHAN & MICHAEL R. FISCHER, AN OVERVIEW OF TAKEOVER REGIMES IN THE UNITED KINGDOM, FRANCE AND GERMANY, (Latham & Watkins, 2003), at http://www.lw.com/resource/publications/_pdf/pub485.pdf (last visited March 29, 2004).

148. FINANCIAL SERVICES AUTHORITY, THE CODE OF MARKET CONDUCT (FSA Handbook, Release 026 2003), *available at* http://www.fsa.gov.uk/handbook/BL2MARpp/Mar/Chapter_1.pdf (last visited March 29, 2004).

149. FINANCIAL REPORTING COUNCIL, THE COMBINED CODE ON CORPORATE GOVERNANCE (2003), *at* http://www.frc.org.uk/documents/pdf/combinedcodefinal.pdf [hereinafter COMBINED CODE] (last visited March 29, 2004).

150. *Id.* at 1.

151. *Id.*

152. *Id* at 7

interfere with the exercise of their independent professional judgment.[153]

The New York Stock Exchange (NYSE) recently acted to require that stock-based compensation plans be approved by the shareholders. Although a version of this rule existed previously, the new rule is more restrictive. Like this provision of the NYSE's listing standards, the Combined Code requires shareholder approval of any new long-term incentive plans.[154] Further, beginning this year, shareholders are required to approve the compensation report to shareholders.[155]

Institutional investors have great influence in the UK, just as they do in the United States. Pension funds, in particular, may hold a large percentage of the stock of a company Many institutional investors in the UK have issued their own corporate governance guidelines, and will vote the stock they hold in accordance with the governance principles set forth in those guidelines. The role of institutional investors in the UK will evolve in coming years from simply voting the shares they hold to engaging management in dialogue regarding significant governance issues.

Although many countries are following the lead of the United States with respect to governance practices, the United States has begun to follow the lead of the United Kingdom in at least one respect.[156] In the United Kingdom, the roles of the chairman and the chief executive officer have been separate for many years.[157] Only recently has this become more commonplace in the United States.

Further governance reforms appear to be needed in the UK. The Institute of Internal Auditors for the UK and Ireland is firmly of the opinion that additional work is needed in the governance area to reach the point at which investors can have a higher level of confidence in the governance practices of UK companies.[158] Specifically that organization has concluded that the UK should migrate from the comply and explain approach to more of a rules-based approach that enforces compliance with governance principles.[159]

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153. *Id.*

154. COMBINED CODE, *supra* note 149, at 14.

155. Disapproval would have no legal effect, but would be an indicator to the full board of the shareholders' dissatisfaction with its actions in the area of compensation.

156. *US Heading for UK-style Governance*, CORP SECRETARY 7 (Feb./March 2003).

157. AccountancyAge.com, *FTSE-100 Fails to Deliver on Higgs*, (Feb. 7, 2003), *at* http://www.accoutancyage.com/News/1132457 (last visited March 29, 2004). Despite the separation of roles which has been the clear best practice for many years in the UK, five percent of companies there still combine the roles. There are no legal prohibitions against combining these roles. *Id.*

159. INSTITUTE OF INTERNAL AUDITORS – UK AND IRELAND, A NEW AGE FOR CORPORATE GOVERNANCE REFORM 3 (2002), *at* http://www.blindtiger.co.uk/IIA/uploads/-38c9a362-ed71ce5fa5—72ff/CorporateGovernanceReformJuly2002.pdf (last visited March 29, 2004).

160. *Id.* at 6. Among other changes recommended by the Institute are that public companies should be required to assess the effectiveness of their internal controls and make disclosures with respect to the effectiveness. This is similar to the requirement set forth in Section 404 of the Sarbanes-Oxley Act.

## CONCLUSION

Over the next few years, whether current efforts to reform corporate governance practices around the world are successful will be seen through the eyes of investors. If the world's capital markets perform well, this will be an indication that the degradation of investor confidence in recent years has been arrested and, perhaps, reversed. International organizations will continue to play a key role in formulating governance principles that have international currency Regulators must continue to work together very closely to assure that laws and regulations passed by various countries allow for the free flow of capital into and out of the global capital markets. Finally we are likely to see a continued migration away from principles-based governance to the rules-based governance of the United States.

# CORPORATE GOVERNANCE: SARBANES-OXLEY ACT, RELATED LEGAL ISSUES, AND GLOBAL COMPARISONS

JOHN M. HOLCOMB

*"I don't sense an enthusiastic pursuit of the fundamental principles of corporate governance even today. I see a reluctant minimalist approach, staying one step ahead of the regulators more than anything else. I am trying to find my own way in getting a stronger board and stronger shareholder involvement on the issues. If you re not utterly insensitive to matters, you have to agree that shareholders are getting more active and restless. They want more say."*[1]

When even a leading corporate CEO such as Andrew Grove is skeptical of the system of corporate governance in place today at most corporations, there is a real problem. Many of the corporate scandals of the past two years come back to the deficiencies in corporate governance. At Enron and other companies, the focus was on the failure of the audit committee of the board of directors. At Tyco and WorldCom, the focus was on the willingness of the board to approve lavish loans and compensation for the CEO and other top officers. At other companies, the focus has been on both the structure and composition of the board, and particularly on its lack of independence. We should remember, however, that in terms of independence, some consider the Enron board to have been a model board of directors.

## HISTORICAL EVOLUTION

Reform of corporate governance is not a new issue. It is now simply a more compelling and urgent issue, perhaps because adequate responses were not forthcoming earlier. Ever since the 1970s, there has been a concern about the

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1. Patrick McGeehan, *Can Annual Meetings Restore Trust?* N.Y TIMES, May 11, 2003, at 3.1 (quoting Andrew S. Grove, Chairman of Intel).

independence of the board. Irving Shapiro, then CEO of DuPont, was one of the leading spokespersons for greater board independence and for an infusion of independent outside directors. Diversity on the board became an issue as well in the 1970s, partially in response to the civil rights era and to issues of minority and women's rights. These were modest suggestions at the time, in contrast to Ralph Nader's more aggressive call for federal chartering of corporations. In the 1976 book *Taming the Giant Corporation*, he and Joel Seligman criticized the lenient governance standards imposed on corporations through the state chartering mechanism, especially for those major companies chartered in the state of Delaware.[2] They proposed instead that corporations be chartered by the federal government and that every corporation with over $700 million in assets have a board of nine members, representing various corporate constituents, including workers, consumers, suppliers, environmental advocates, and community members.[3]

That proposal strikes at the heart of the ongoing debate over corporate governance – to whom should corporations be ultimately accountable, shareholders or stakeholders? The classical corporate model or ownership model would answer "shareholders."[4] The more modern theory would answer "stakeholders."[5] Some claim that is more consistent with the managerial model of most large corporations, though others claim the managerial model has degenerated into a form that elevates managerial self-interest and executive ego over the interests of any stakeholders.[6] The separation of ownership and management characteristic of the large modern enterprise analyzed by Adolph Berle and Gardiner Means in the classic work *The American Corporation* and a large body of literature on the issue, has spawned a governance trap.[7] With no real consensus on the accountability

2. *See* RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976).

3. *Id.*, *See also* Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 574 (1984) (containing a sympathetic discussion of this proposal).

4. Milton Friedman, *The Social Responsibility of Business is to Increase its Profits*, *in* ETHICAL THEORY AND BUSINESS (Tom L. Beauchamp & Norman E. Bowie eds., 6th ed. 2001).

5. R. Edward Freeman, *A Stakeholder Theory of the Modern Corporation*, *in* ETHICAL THEORY AND BUSINESS (Tom L. Beauchamp & Norman E. Bowie eds., 6th ed. 2001) (leading work on stakeholder theory or the stakeholder approach); *see also* MARGARET M. BLAIR, OWNERSHIP AND CONTROL. RETHINKING CORPORATE GOVERNANCE FOR THE TWENTY-FIRST CENTURY (1995) (setting forth an approach that blends accountability to stakeholders with the fiduciary duty to shareholders); *See also* J.A. CONGER, ET AL, CORPORATE BOARDS: NEW STRATEGIES FOR ADDING VALUE AT THE TOP CH. 9 (2001); STEVEN WALKER & JEFFERY MARR. STAKEHOLDER POWER: A WINNING PLAN FOR BUILDING STAKEHOLDER COMMITMENT AND DRIVING CORPORATE GROWTH 2001 (an example of modern executives have also largely embraced the stakeholder approach).

6. *See generally* KEVIN PHILLIPS, WEALTH AND DEMOCRACY 317-46 (2002) (detailing a historical and political perspective on executive abuses). *See also* Jack Bogle, What Went Wrong in Corporate America, Community Forum Distinguished Speaker Series (February 25, 2003), transcript available at http:www.vanguard.com/bogle_site/sp20030224.html (last visited Feb. 14, 2004) (Jack Bogle, founder of the Vanguard Group, and Peter Peterson, former Secretary of Commerce and co-chair of the Commission on Public Trust of the Conference Board, have spoken widely before many pubic forums and in congressional testimony about executive greed and abuses.). For historical and political perspective on executive abuses, see KEVIN PHILLIPS, WEALTH AND DEMOCRACY· A POLITICAL HISTORY OF THE AMERICAN RICH, CH. 8 2002.

7 ADOLPH A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE

model of the corporation, there is much confusion and disagreement over just how it should be governed.

The need for a committee structure on the board became a prominent issue in the 1970s as well.[8] With the scandal over inappropriate payments to foreign government officials in the early 1970s and the subsequent passage of the Foreign Corrupt Practices Act in 1977 the requirement that corporate boards have an audit committee became a legal requirement.[9] Corporate public policy or public responsibility committees became more common among Fortune 500 companies at the time as well.[10] In response to a shareholder resolution that Ralph Nader filed against General Motors as part of his Campaign GM, requesting that the company form such committee, the company did so.[11] A few years thereafter, a survey by the Conference Board found that over a hundred companies had formed such board committees.[12]

Beyond audit and public policy committees, the gradual formation of nominating and compensation committees also followed over time. Nominating committees were a response to the need to both diversify boards and to identify outside directors not beholden to CEOs.[13] Compensation committees were a response to the need for a check and independent voice on decisions over executive compensation, and they have assumed an even larger significance with the rising controversy over CEO compensation.[14] The latter issue is examined in another section of this article, but it is inextricably tied to the issue of corporate governance. In fact, some see it as the major unresolved issue of corporate accountability and credibility, even with the Sarbanes-Oxley law and other recent reforms.[15] In terms of public perception and corporate image, it leaves a more indelible impression on the public than any other issue. It also goes beyond corporate accountability and is symbolic of the issue of social justice that heavily

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PROPERTY 4 (1932).

8. Michael L. Lovdal, *Making the Audit Committee Work*, HARV. BUS. REV., Mar.-Apr. 1977, at 108, 108-9. (There has been growing recognition of the importance of board committees for large corporations over time.). *See also* The Business Roundtable, *Principles of Corporate Governance*, May 2002, at 14, *available at* http://www.businessroundtable.org/pdf/704.pdf (last visited Feb. 24, 2004) (The Business Roundtable has stated that it believes that the functions generally performed by the audit, compensation and corporate governance committees are central to effective corporate governance.").

9. RICHARD SCHAFFER ET AL., INTERNATIONAL BUSINESS LAW AND ITS ENVIRONMENT 503 (2002).

10. Michael L. Lovdal et al., *Public Responsibility Committees of the Board*, HARV BUS. REV May-June 1977, at 40, 40-41.

11. JOHN H. JACKSON, BUSINESS AND SOCIETY: MANAGING SOCIAL ISSUES 370 (1997).

12. PHYLLIS MCGRATH, CORPORATE DIRECTORSHIP PRACTICES: THE PUBLIC POLICY COMMITTEE. RESEARCH REPORT NO. 775 (1980).

13. Jeffrey A. Sonnenfeld, *What Makes Great Boards Great*, HARV. BUS. REV., Sept. 2002, at 106, 113.

14. *Id.* at 109 (citing a 2001 study from the National Association of Corporate Directors and Institutional Shareholder Services of 5,000 public company boards showing that 99 percent have audit committees and 91 percent have compensation committees).

15. *Treasury Snow Says Corporate Reform Includes Executives Pay*, Oct. 16, 2003, at ¶ 2, *at* http://usinfo.state.gov/ei/Archive/2004/Jan/06-631299.html (last visited Mar. 10, 2004).

resonates with a large portion of the public.

*Duties of Directors*

Beyond the structure and composition of the board, the legal duties of the directors have also become more stringent over time. Historically good-faith errors in judgment by board members enjoyed the defense of the business judgment rule, a rather permissive rule that prompted a court to defer to business judgment rather than substitute its own. The Delaware Chancery Court issued many decisions providing for a wide expanse of managerial prerogative.[16] Over time, however, even the Delaware courts have begun to demand more in the way of due care and diligence, informed decision-making, and independent judgment by corporate directors, through such decisions as *Smith v. Van Gorkum*.[17] Regarding board member independence, there is one major point of legal vulnerability for many current board members and that is potential conflicts of interest they might have as insiders or quasi-insiders.

*Board-Management Relations*

In the midst of rising concerns over CEO compensation and with the greater role now being played by outside directors, evidence exists that boards are being tougher in holding CEOs accountable.[18] In their annual survey of CEO turnover, Booz Allen Hamilton experts have found that performance-related turnover reached a record high in 2002.[19] It constituted 39 percent of all CEO successions, including those who voluntarily retired and merger-related turnovers.[20] The highest rates of performance-related turnover were in the information technology telecommunications services, and consumer discretionary industries.[21] The most impressive finding is that the "return gap" – the difference in the total shareholder return between a company's return and the total market return for voluntarily retired and fired CEOs – declined to 6.2 in 2002 from 13.5 in 2000 and 11.9 in 2001.[22] This demonstrates that boards are now judging CEOs more harshly and that forced dismissals took place for underperformance that earlier would have been tolerated.

Despite the renewed assertiveness of some boards, the examples of recent board failures are many Most often, those failures have been due to inattention

16. This phenomenon is what many critics have labeled the "race to the bottom" in terms of attracting corporations and generating chartering fees by conditions friendly to management; a race that Delaware seems to have won.

17 Smith v. Van Gorkum, 488 A.2d 858, 872-73, 893 (1985).

18. Patrick McGeehan, *Study Finds Number of Chiefs Forced to Leave Jobs Is Up*, N.Y TIMES, May 12, 2003, at C2.

19 Chuck Lucier, et al., *CEO Succession 2002: Deliver or Depart*, STRATEGY + BUSINESS, Summer 2003, at 1-2, *available at* http://www.strategy-business.com/press/article/21700?pg=0 (last visited Feb. 28, 2004).

20. *Id.* at 4.

21. *Id.* at 8-11.

22. *Id.* at 8.

rather than lack of independence, although there is sometimes a mixture of the two. The Freddie Mac case is an instructive one.[23] A series of interviews related to the Freddie Mac accounting issues "shows a board whose members struggled, and sometimes hesitated, to take tough action against top executives they had known and respected for years."[24] The board's audit committee finally hired former SEC General Counsel James Doty to conduct an investigation, later broadening that investigation and requesting a report to the full board.[25] The firm's auditor, PricewaterhouseCoopers (PwC), refused to accept representations from Freddie Mac's president and chief operating officer, and Doty found pages deleted from the COO's diary that may have shown his direct involvement in the accounting problems related to over one trillion dollars of derivatives and an effort to hide fluctuating earnings and create an impression of smooth earnings growth over time.[26] The board, initially wanting the COO to resign, only then decided it must fire him, and forced out the CEO and chief financial officer as well.[27] While Doty's report "largely absolves the board, saying that management withheld key information from the board, other finance experts believe the report is too soft on the board, that the board "should have been more aggressive, asked more questions and relied less on what officials were telling them."[28] *The Economist* found the following as key features of the Freddie Mac crisis: "missing documents; lavish executive pay· uncooperative directors; and indications that Freddie Mac's reported figures are wrong, and its internal controls are in chaos."[29]

Subsequent to forcing out the three top officers, the board then promoted the chief investment officer to be president and CEO.[30] However, the Doty report directly implicates him as well in circumventing new derivatives accounting rules and even in dividing the derivatives transactions so they would not have to be disclosed to the board. One business reporter therefore concludes, "Restoring Freddie's credibility ought to mean getting rid of everybody involved – up to and including the board of directors."[31] The Doty report found that the tone of the organization and goal of attaining smooth reporting earnings for "steady Freddie" was set at the top.[32] Another report concludes:

> The convoluted strategies Freddie Mac employed ultimately failed, contributing to as much as $4.5 billion in accounting errors [and] provide some of the most vivid illustrations since the collapse of Enron Corporation of the lengths to which corporations have gone to circumvent accounting rules and manipulate the

23. Kathleen Day, *A Reluctant Coming to Grips at Freddie Mac*, WASH. POST, July 10, 2003, at E1.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*, Kathleen Day, *Freddie Mac Told to Remove CEO*, WASH. POST, Aug. 22, 2003, at E1.

28. Kathleen Day, *Report Faults Freddie Mac Officials*, WASH. POST, July 24, 2003, at E1.

29. *Trouble at Home*, ECONOMIST, June 14, 2003, at 70.

30. Day, *supra* note 28.

31. Jerry Knight, *At Freddie Mac, It's Hard to Lay Claim to Innocence*, WASH. POST, July 28, 2003, at E1.

32. *See* Day, *supra* note 28.

numbers they disclose to the investing public.[33]

*Outside or Independent Directors*

The debate over corporate governance has emphasized, and some would argue has overemphasized, the importance of companies having outside or independent directors on the board. That was emphasized by early reformers and is a key component of the Sarbanes-Oxley provisions and the NYSE standards, requiring that key board committees be composed entirely of outsiders.[34] Outsiders, and especially genuinely independent directors, are ostensibly less prone to defer to the CEO and may bring broader perspectives to board deliberations. Anecdotal evidence suggests that outside directors are also becoming more actively engaged in corporate decision-making.[35] One study found that when such outsiders serve on a network of multiple boards, they may diffuse positive standards of CEO compensation and of useful strategic lessons among several firms.[36]

Beyond the legal duties of directors, the powers of the board include those of both monitoring the behavior of management and more actively contributing to strategic policy-making. Both require a certain detachment from management and independence from management influence.[37] Hence, a great debate has ensued over the need to have more outside or independent directors on the board. If a director has business or personal ties to corporate management, he or she might too easily be influenced into rubber-stamping management decisions. The control exerted by management over directors and the "cozy" relationship between the two is the most common criticism of corporate governance. The criteria for determining a genuinely "independent" director is of course subject to debate, and to be independent does not guarantee a board member will be actively engaged in his or her board responsibilities.

Both the regulators and the academic literature favor independent rather than inside directors. The academic literature does so because it is based on agency theory, which sees the key role of boards as being the control or monitoring function.[38] It is reasonable that independent directors, less related and beholden to the CEO, would be more effective monitors. However, a competing theory, that of

33. David S. Hilzenrath, *Strategy Aimed to Circumvent New Rule*, WASH. POST, July 28, 2003, at E1.

34. Lovdal, *supra* note 8, at 108-9.

35. Carrie Johnson, *Corporate Audit Panels to Gain Power*, WASH. POST, Apr. 2, 2003, at E2 (citing Charles M. Elson, director of the Center for Corporate Governance at the University of Delaware, who has noticed audit committees are meeting more often and seeking more outside advice since the collapse of Enron).

36. James D. Westphal, et al., *Second-order Imitation: Uncovering Latent Effects of Board Network Ties*, ADMIN. SCI. Q., Dec. 2001, at 717

37. *See* CONGER, *supra* note 5, ch. 2; Sonnenfeld, *supra* note 13, at 111 (stressing that a culture of open dissent within the board is even more important than dominance by outside directors).

38. Amy J. Hillman & Thomas Dalziel, *Boards of Directors and Firm Performance: Integrating Agency and Resource Dependence Perspectives*, 28 ACAD. MGMT. REV. 383, 383-84 (2003).

resource dependency, suggests that the board provides much more than a control function and that it also provides a wide range of resources or capital to the corporation beneficial to business and strategic decisions.[39] Based on this theory dependent directors from the firm's customers, suppliers, consultants, or bankers might actually have a greater incentive to supply "board capital" since they would stand to gain more from the contribution than would completely detached outsiders.[40] Based on this analysis, the firm would gain more from a board composed of both dependent and independent directors, rather than one dominated by independent directors. However, the dependent directors need not be corporate insiders in the strictest sense of that term, i.e., employees of the firm. It is not necessary that they actually be on the board for the directors to gain from their insights and input. Outside directors should be able to question key insiders at anytime for relevant information and some companies are even structuring such interaction to ensure that directors are informed of new developments within the firm.[41]

This may also explain why a meta-analysis of all studies on the link between board composition and financial performance[42] found there is no positive correlation between firm financial performance and a large proportion of outsiders on a corporate board.[43] Further, both Enron and Tyco had boards with a heavy presence of outside directors and might be considered model boards, yet they failed in dramatic fashion.[44] Hence, the culture of firm and the board, along with other best board practices, may be more important than the presence of outsiders on the board, as required or promoted by Sarbanes-Oxley and the standards of the stock exchanges.[45]

The life cycle and tenure of the CEO, and even of the firm, may further complicate the value of dependent and independent directors at any given point in time. One study argues that early in a CEO's tenure, especially one hired from outside the firm, the board must play a greater role in leadership development than in monitoring opportunistic behavior.[46] Cultivating leadership might call for a combination of backgrounds and skills from both independent and dependent directors.

*Separation of Chairman and CEO*

The separation of the positions of chairman and CEO is seen by some experts

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39. *Id.* at 385-388.

40. *Id.* at 391.

41. Saul Gellerman, *Why Corporations Can't Control Chicanery*, 46 BUS. HORIZONS 3, 17-24 (2003).

42. Dan R. Dalton, et al., *Meta-Analytic Reviews of Board Composition, Leadership Structure, and Financial Performance*, 19 STRATEGIC MGMT. J. 269, 269-70 (1998).

43. *Id.* at 280.

44. Sonnenfeld, *supra* note 13, at 108.

45. *Id.* at 109-113.

46. Wei Shen, *The Dynamics of the CEO-Board Relationship: An Evolutionary Perspective*, 28 ACAD. MGMT. REV 466, 466-67 (2003).

as even more important than dominance by independent directors on the board, but it is an area where little progress has been made by U.S. corporations. According to a study by The Corporate Library, only fifteen of S&P 500 corporations have an independent director as chairman.[47] More common has been a compromise measure of selecting a lead outside director to preside over board meetings even when the CEO is chairman.[48]

*Best Board Practices*

Along with new actors and new aspects of shareholder activism, there is also an evolving discussion and study of "best practices" in corporate governance. That list has expanded from the traditional list of director independence and committee structures.[49] Various advocates are now emphasizing such new board practices as:

> Separation of Chairman and CEO Positions;
> Lead Director Position;
> Totality of Independent Directors (as at American Standard, Baxter Healthcare, and Fortune Brands);
> Limits on Number of Multiple Directors (numbers of board seats held);
> Downsizing of Boards (Crandall, former CEO of AMR recommends six to eight members and no committees);
> Board Meetings without Management
> More Frequent Meetings and Staff Support;
> Frequent and Complete Disclosure of Information to the Board;
> Stock Ownership by Board Members, but no options;
> Evaluations of Corporate Governance Process;
> Board Committee on Corporate Governance; and,
> Limit CEOs and Directors on Each Other's Boards[50]

Whatever measures are taken voluntarily or mandated by the SEC, some advocates contend that they all fall short. Jeffrey Sonnenfeld, Associate Dean of the Yale School of Organization and Management, claims it all comes down to corporate culture.[51] There must be a culture of independence on the board, in substance and not just in form. Independent directors must be inquisitive and challenging, and dissent must be respected and encouraged by senior management for genuine checks and balances to exist. Independent directors of stature,

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47 Ben White, *Save the Chair for the Chief?* WASH. POST., Feb. 7, 2003, at E1; *see also* The Corporate Library, *Exclusive Special Report on CEO/Chairman Splits in the S&P 500: How Many and How Independent?* Feb. 2003, *at* http://www.thecorporatelibrary.com/study/spotlight.asp (last visited Feb. 29, 2004) (containing multiple corporate studies).

48. Paul Kocourek, et. al., *Corporate Governance: Hard Facts About Soft Behaviors*, STRATEGY + BUSINESS, Spring 2003, at 1, *available at* http://www.strategy-business.com/press/article/8322?pg=0 (last visited Jan. 30, 2004); Mary Williams Walsh & David Leonhardt, *To Rein in Abuses, Executives Get Watchdogs*, N.Y TIMES, July 5, 2002, at C1.

49. *See* Sonnenfeld, *supra* note 13, at 106-109 (detailing traditional board structures); Nell Minnow, *Stockholders Would Benefit From More Board Flexibility*, USA TODAY, Sept. 16, 2002, at 13A (detailing emerging board best practices).

50. Sonnenfeld, *supra* note 13, at 112-13; Minnow, *supra* note 49.

51. Sonnenfeld, *supra* note 13, at 109.

expertise, and standing must be appointed.[52]

In keeping with Sonnenfeld's views, others have also suggested that qualitative reforms going well beyond the requirements of Sarbanes-Oxley may do much more to improve corporate governance.[53] Kocourek, Burger, and Birchard emphasize the following key ingredients: (1) Select the right directors: one study by Korn/Ferry found that current directors rate "willingness to challenge management" as the number one criteria for a good director;[54] (2) Training of directors: a major failing of most corporations, but Pfizer is an example of a company that does an excellent job; (3) Inform and empower directors: they need a constant flow of information, ready access to key managers, and both financial and nonfinancial measures of company progress; (4) Counterbalance the CEO: separating the positions of chairman and CEO is necessary and far better than just having a lead director, and the board nominating committee must have more power than the CEO in selecting future directors; (5) Nurture a culture of collegial questioning: while being a partner with the CEO, strong-willed directors must also challenge and disagree; (6) Devote an adequate amount of time: directors must devote 100-200 hours a year to a board, and perhaps 300 hours for audit committee members;[55] (7) Measure board performance: studies show a small percentage of boards face up to this need, but surveyed directors recognize its value.[56]

Continuing with the emphasis on director diligence, as opposed to independence, another author suggests ways of increasing the time invested by directors and expanding their control. One argues in favor of full-time directors, who view that job as their primary responsibility and serve on only one corporate board.[57] Such directors would also be given "the authority of a military inspector-general, with the right to question anyone within the company and impose sanctions on them.[58]

Finally, for corporate governance to really work, cooperation must exist between the corporate community and business policy organizations on the one hand and self-regulatory bodies and government regulators on the other. Each must respect the professionalism of the other. The adversary spirit long dominant between business and regulators will impede progress on the road to reform. All must march together in the same direction.

*Shareholder Rights*

In the 1970s, much of the incipient changes in corporate governance related to the structure and composition of the corporate board.[59] However, there also was

52. *Id.* at 113
53. Kocourek, *supra* note 48, at 12.
54. *Id.* at 5.
55. *Id.* at 11.
56. *Id.* at 4-5.
57 Gellerman, *supra* note 41.
58. *Id.*
59. Lovdal, *supra* note 8, at 108-10; JACKSON, *supra* note 11, at 367-370.

movement in the area of shareholder rights and powers as well. Shareholders have historically enjoyed and used the following legal powers:

> Voting – to vote for or against directors, usually a management slate of directors, as well as to vote on proxy resolutions. There has also been a modest campaign for the system of cumulative voting, which would give dissident directors more concentrated power in electing some representatives to the board.
> Inspecting the Books – beyond having access to the 10-K report and other corporate disclosures, shareholders sometimes legally demand and receive access to more detailed financial information, under special circumstances and when it is in their material interests.
> Lawsuits – shareholders can bring individual, class action, or derivate suits against management when they have been injured by management mistakes.
> Wall Street Rule – the final power by shareholders has been that of exiting or selling their shares when they disagree with the direction of the company and decisions of management.
> Shareholder Resolutions – they can file a resolution on a corporate policy with which they disagree, to be voted upon by all shareholders, when they own $2,000 worth of stock.[60]

It is the final power of introducing shareholder resolutions that has become ever more prominent since the 1970s. The SEC has periodically ruled on the criteria that such resolutions should meet, which can be disqualified by management, and the votes required for resubmission of such resolutions.[61] Organized shareholders, though, have been the driving force behind what has really become a movement of shareholder resolutions. The radical organizer Saul Alinsky used resolutions as an organizing strategy in the 1950s;[62] Nader later used them for a time in the late 1960s;[63] and the National Council of Churches really promoted their widespread use since that time.[64] Its Interfaith Center on Corporate Responsibility annually sponsors hundreds of shareholder resolutions.[65] Other religious and labor organizations now sponsor resolutions as well.[66]

As an indication of their growing impact, the Investor Responsibility Research Center (IRRC) formed in 1973 to monitor shareholder resolutions and to advise institutional investors on how to vote their shares.[67] Most of the resolutions

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60. ARTHUR LEVITT, TAKE ON THE STREET 211-212 (2002).

61. Security Exchange Act of 1934, § 14(a)(8), 17 CFR 1.

62. SANDOR D. HORWITT, LET THEM CALL ME REBEL. SAUL ALINSKY, HIS LIFE AND LEGACY (1989).

63. JACKSON, *supra* note 11, at 370.

64. *Id.*

65. Interfaith Center on Corporate Responsibility, Companies, Resolutions and Status: 2002-2003 Season, *at* http://www.iccr.org/shareholder/proxy_book03/03statuschart.php (last visited Feb. 14, 2004) (listing continual update on these resolutions); The Corporate Library, News Briefs, *at* http://www.thecorporatelibrary.com/news/default.asp (last visited Feb. 14, 2004) (featuring articles on shareholder activism).

66. The Corporate Library, News Briefs, *supra* note 65.

67 The Investor Responsibility Research Center Library, *at*

of the 1970s and 1980s related to the social impact of corporate policies, such as disclosure of EEO data, investment in South Africa, development of nuclear power, or animal testing.[68] Reflecting current times, shareholder resolutions more commonly focus today on mainstream corporate governance issues, such as the separation of the office of CEO and chairman of the board, the demand for more independent directors, or reform of CEO compensation.[69]

## NEW ELEMENTS IN CORPORATE GOVERNANCE

In terms of what is new in shareholder activism, the upsurge in activism by mainstream shareholders on mainstream issues tells the tale. No longer are liberal church groups and other cause organizations the only ones sponsoring resolutions on largely social issues. Even before the wave of corporate scandals, corporate governance had become a growing concern among institutional investors. Beyond the formation of the IRRC in 1973, other organizations formed to assist institutional investors in the 1980s, including Institutional Shareholder Services, Inc.[70] James E. Heard, an organizer of IRRC, is now a principal in this firm.[71] In fact, boards and senior management might have seen the earlier activism on corporate governance as an early-warning signal to its importance as an issue. Regulators might likewise have paid closer attention.

Now, in the wake of the scandals over management and board misconduct, other organized interests have entered the arena. The Council of Institutional Investors, along with state pension funds, is playing a greater role in pressuring management and boards on corporate governance and executive pay issues.[72] The rating agencies, such as Standard & Poor's and Moody's, are now involved in evaluating the governance mechanisms and systems of the companies they

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http://www.irrc.org/resources/library.htm (last visited Feb. 20, 2004) (providing some of IRRC's research which is known as fair and objective).

68. *See* DAVID VOGEL, LOBBYING THE CORPORATION: CITIZEN CHALLENGES TO BUSINESS AUTHORITY 69-125 (1978); *see also* PATRICIA O'TOOLE, MONEY & MORALS IN AMERICA 300-27 (1998).

69. Robert D. Hershey, *Investor Angst Prompts Funds to Speak Up*, N.Y TIMES, July 7 2002, at 3.5; *see also* The Corporate Library, Shareholder Proposals, *at* http://www.thecorporatelibrary.com/shareholder-action/shareprops/default.asp (last visited Feb. 14, 2004) (containing submitted shareholder proposals); CalPERS, Shareholder Action, *at* http://www.calpers-governance.org/alert/default.asp (last visited Feb. 14, 2004) (detailing CalPERS' policies on exercising its voting rights); TIAA-CREF TIAA-CREF Publications, *at* https://www5.tiaa-cref.org/bookstore/list.do?cat=6 (last visited Feb. 14, 2004) (containing TIAA-CREF's investment philosophies); AFL-CIO, Executive PayWatch, *at* http://www.aflcio.org/paywatch (last visited Feb. 14, 2004) (covering executive compensation trends, issues, and resolutions).

70. Institutional Shareholder Services, Company Profile (2004), *at* http://www.issproxy.com/about/index.asp (last visited Jan. 27, 2004) (Institutional Shareholder Services (ISS), Inc. is a for-profit proxy monitoring service.). For a critique of ISS's potential conflicts of interest, see Adam Lishinsky, *ISS Wants Business Both Ways*, FORTUNE, June 16, 2003, at 24.

71. Institutional Shareholder Services, Company Profile, *supra* note 70 (information about staff and operations).

72. *See* Council of Institutional Investors, What We Do, *at* http://www.cii.org/dcwascii/web.nsf/doc/what_index.cm (last visited Feb. 29, 2004) (information on its corporate governance activities).

evaluate.[73] Finally, there are new companies that have been recently formed to sell services on corporate governance evaluation, such as Governance Metrics International.[74] Investors are beginning to focus much more on governance evaluation, partially because studies increasingly show a positive relationship between "good governance" and financial performance.[75] That field of study will likely grow even more as the corporate governance issue remains high on the agenda.

Organized political interests have also taken positions on corporate governance. The Business Roundtable has promoted the need for more independent boards, even while it takes a cautious stance on the expensing of stock options.[76] The Conference Board formed a Commission on Public Trust and Private Enterprise, co-chaired by former Commerce Secretary Peter Peterson and John Biggs of TIAA-CREF [77] and it has stressed the need for more scrutiny and independence on corporate boards, as well as the expensing of stock options.[78]

John Bogle, a member of the Commission and founder of the Vanguard Group, has emerged as a leading activist in favor of corporate governance reform.[79] He has been a critic of both the gatekeepers and monitors, such as corporate boards, regulators, and legislators, as well as of investors themselves. He believes the mutual funds must step to the plate in monitoring the governance of companies in which they invest. As he puts it:

> Even after the bear market that devastated the value of our clients' equity holdings, the only response we've heard from the mutual fund industry is the sound of silence. We need to return to behaving as *owners* rather than *traders*, to return to principles of prudence and trusteeship rather than of speculation and salesmanship, and to return to acting as good stewards of the assets entrusted to our care.[80]

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73. *See* Standard & Poor's, Governance Services, *at* http://www.standardandpoors.com (last visited Jan. 26, 2004).

74. *See* Governance Metrics International, About Us: Overview, *at* http://www.gmiratings.com (last visited Feb. 29, 2004).

75. *See* Jeanne Patterson, The Patterson Report: Corporate Governance and Corporate Performance Research (2003), *available at* http://www.thecorporatelibrary.com/Governance-Research/patterson-report/patterson.asp (last visited Mar. 11, 2004). *See also* The Corporate Library, Governance Research (2004) (containing multiple studies), *at* http://www.thecorporatelibrary.com/Governance-Research/default.html (last visited Mar. 11, 2004).

76. The Business Roundtable, *Principles of Corporate Governance*, (May, 2002) *at* http://www.businessroundtable.org/pdf/704.pdf (last visited Feb. 29, 2004).

77 The Commission on Public Trust and Enterprise, (2004), *at* http://www.conference board.org/knowledge/governCommission.cfm (last visited Mar. 2, 2004) (Co-chair Biggs was an erstwhile candidate to head the Public Company Accounting Oversight Board, established by the Sarbanes-Oxley Act, while Harvey Pitt was still Chairman of the SEC, but his candidacy met with substantial business opposition.).

78. The Commission Board, *Commission on Public Trust & Private Enterprise: Findings & Recommendations*, Jan. 9. 2003, at 38-39, *at* http://www.conference-board.org/pdf_free/758.pdf (last visited Mar. 2, 2004).

79. *See* Bogle, *supra* note 6.

80. *Id.*

One other major issue is of renewed concern for shareholders, that of transparency Disclosures of all sorts of corporate practices related to the governance system, to accounting, and to the means of evaluating executive performance and compensation are being promoted by shareholders. The SEC has unanimously proposed a rule requiring greater disclosure on how corporate directors are selected, including policies on how directors are nominated, the minimum qualifications to serve on the board and how candidates came to the attention of the board.[81]

*Shareholder Nomination of Directors*

Historically, shareholders have had limited powers in nominating directors due to management's control of the proxy machinery Shareholders' ability to nominate directors and participate in board elections has been undermined by the huge financial barriers of financing a campaign for their own nominees. Corporations enjoy the power to finance campaigns and proxy materials for only those candidates nominated by the corporate board. Shareholders therefore face a slate of choices selected by the company Outside candidates must present shareholders with an alternative ballot at their own expense. As one business writers concludes, "Most significant [even after Sarbanes-Oxley], the very heart of corporate governance, the election of directors, is still a sham. The shareholder ballots you receive with your proxy materials are just like those Stalin used to distribute. For every position there is exactly one candidate. Please mark your choice."[82]

However, the SEC is now considering a rule which would allow significant and long-time shareholders, those with more than 3 to 5 percent of corporate ownership, to nominate their own directors.[83] Shareholder activist Evelyn Y Davis and corporate governance expert Charles Elson are concerned that such a high threshold might set a precedent for elevating the share holding requirement to sponsor shareholder resolutions from the current level of one percent or $2,000 of shares, but the SEC has defeated such moves in the past.[84] The rule may allow shareholder nominations when certain triggering events occur, such as a company's failure to implement the terms of shareholder resolutions enjoying wide support that call for changes in corporate governance, or when shareholders have expressed widespread dissatisfaction in the current board.[85] Some experts fear that if support for shareholder resolutions becomes a triggering event, then corporations will fight earlier and harder to heavily defeat such resolutions.[86]

Another rule proposed by the SEC would require disclosure of nominating or governance committee actions on shareholder candidates. The board would have

81. Carrie Johnson, *SEC Votes to Propose Director Rules*, WASH. POST, Aug. 7, 2003, at E3.
82. Geoffrey Colvin, *Shareholders are No Fools Anymore*, FORTUNE, July 7, 2003, at 42.
83. Charles Duhigg, *SEC May Aid Rebels Seeking Board Seats*, WASH. POST, Aug. 6, 2003. at E1.
84. *Id.*
85. *Id.*
86. *Id.*

to explain why it found unacceptable a board candidate nominated by shareholders who owned more than 3 percent ownership stake for the past year.[87]

Some corporate governance reformers, such as Nell Minow and the AFL CIO, see shareholder empowerment as bringing more fundamental change in corporate governance than does the Sarbanes Oxley Act, through the presence of more "outside directors" chosen by the board itself.[88] Opponents, such as Henry Manne, notable expert in the law and economics movement, believe that empowering shareholders in director elections will create mischief by creating too much corporate democracy and paralyzing corporate decision-making with the presence on the board of activist shareholder representatives.[89] Even moderate critics reject the "romantic notion that corporations should be laboratories of democracy, and conclude that "running a corporation requires more stability and internal harmony than the democratic model allows."[90] For these reasons, leading business lobbies like the Business Roundtable have opposed the new rule, saying it would "turn every director election into a divisive proxy contest."[91] The American Society of Corporate Secretaries and the New York City Bar Association also oppose the rule, contending it would produce divided and unqualified boards.[92] However, to this fear of a balkanized board, other governance experts reply that, "the ideal board candidate is someone with forceful opinions who isn't afraid to share them and that the best boards aren't necessarily those that agree, but those that argue."[93] Some companies, like Apria Healthcare Group and Hanover Compressor, have already allowed shareholder access to the proxy machinery to make director nominations.[94]

*Shareholder Litigation*

Beyond the promotion of these new concerns through shareholder resolutions, there is also a renewed emphasis on shareholder litigation. Many of the scandal-ridden corporations have been the targets of such litigation by pensioners and institutional investors, such as the lawsuit brought against Enron and its creditors by the University of California system.[95] Beyond the suits brought by the leading plaintiff lawyers, such as William Lerach, many established law firms are moving into this line of business, joined by new firms that are carving it out as a niche business.[96] Hence, any corporations and management tinged with legal problems

87. Johnson, *supra* note 81.

88. Minow, *supra* note 49.

89. Henry Manne, *Citizen Donaldson*, WALL ST. J., Aug. 7, 2003, at 10.

90. Steven Pearlstein, *Corporate Reform Could Go Too Far* WASH. POST, July 18, 2003, at E1.

91. Louis Lavelle, *Shareholder Democracy Is No Demon*, BUS. WK. ONLINE, July 2, 2003, at 1, *at* http://businessweek.com/bwdaily/dnflash/jul2003/nf2003072_0829_db042.htm (last visited Mar. 3, 2004).

92. *Id.*

93. *Id.* at 2.

94. *Id.*

95. Jerry Hirsch, *UC Named Lead Plaintiff in Enron Class-Action Suit*, L.A. TIMES, Feb. 16, 2002.

96. *In Praise of Trial Lawyers*, ECONOMIST, July 12, 2003, at 60.

can expect to confront such litigation. Just the investment banks involved in the recent Wall Street settlement may face potential outside liability of up to $82 billion, prior to appeals and out-of-court settlements.[97] Hence, the individual fines and criminal actions, and the billions involved in the settlement, may be just the tip of the iceberg.[98]

Given the requirement of the 1995 Private Securities Litigation Reform Act,[99] that the control of such shareholder suits would rest with that largest investor, attorneys such as William Lerach are now forced to work more closely with institutional investors, which have the largest stakes in the litigation. In representing the University of California against such Enron creditors as Citigroup, J.P Morgan Chase, Bank of America, Goldman Sachs, and Merrill Lynch, Lerach's opening settlement proposal was for $15 billion.[100] He is also trying to persuade the banks to drop their indemnification agreements, which would increase his fees.[101] As the *Economist* comments, "These indemnification agreements throw liability for due-diligence failures back on the company issuing the shares or bonds, making a nonsense of an underwriter's gatekeeping role."[102]

The battle over final liability for the failures of directors and officers, and of investment analysts in other cases, will be fought between the banks and insurance companies. The banks will argue that D&O and E&O insurance policies should cover their liability and even some of the money owed in the $1.4 billion settlement orchestrated by New York Attorney General Eliot Spitzer,[103] while the insurance companies will resist paying, arguing that their policies do not cover fraud and deceit.[104] The contest relates to the larger argument over the appropriateness of D&O indemnification policies. Some like Warren Buffet argue that such policies create a moral hazard and encourage sloppy behavior by directors, so Berkshire Hathaway does not even carry such policies.[105] Xerox Corporation, on the basis of its D&O policy, paid for the disgorgement of $6.4 million of gains due to fraud committed by former CEO Paul Allaire.[106] This is but one example of what some consider the moral hazard created by such policies, in arguing that directors and officers should, at a minimum, purchase their own policies.[107]

*Corporate Governance Ratings*

Given the major failures and blowups in corporate governance, along with the

97. *Id.*
98. *Id.*
99. *Id.*
100. *Id.*
101. *Id.*
102. *Id.*
103. *Whose Skunk Is It?* ECONOMIST, June 7, 2003, at 63-64.
104. *Id.*
105. *Id.*
106. Carrie Johnson, *Former Xerox Officials Settle Case*, WASH. POST, June 6, 2003, at E2.
107. *See Whose Skunk Is It? supra* note 103.

rising interest in the investment community over good governance practices, various organizations that serve business and institutional investors have launched corporate governance ratings services. The two major organizations that advise institutional investors on a wide array of issues – the Investor Responsibility Research Center (IRRC) and Institutional Shareholders Services (ISS) – have both done so.[108] The Corporate Library, a research organization and website directed by Nell Minow, has also developed its own rating system, as has Governance Metrics International, a firm developed specifically to rate corporate governance.[109] Finally Standard & Poor's, a major ratings company has expanded its evaluation of corporations and developed a Global Corporate Governance practice, headed by George Dallas in its London office.[110]

One of the firms, ISS, has already been criticized for possible conflicts of interest in its ratings practice.[111] It offers a service costing $15,000 to corporations that helps them improve their governance ratings, while it also provides the resulting metrics to its institutional investor clients.[112] ISS responds that it maintains a wall of separation between its corporate and client services, but other corporate watchdogs remain critical.[113]

While the major rating firms, such as Moody's and Standard & Poor's have developed corporate governance ratings services, they have also been criticized for failing to alert the investment public to the possibility of unfolding corporate scandals, especially in the case of Enron.[114] A report to the Senate Committee on Governmental Affairs, *Financial Oversight of Enron: The SEC and Private-Sector Watchdogs* criticized the rating companies for failing to probe deeply enough, for focusing on largely short-term issues, and for failing to hold themselves accountable for the accuracy of their reports.[115]

*Corporate Governance and Financial Performance*

Many studies have examined the link between different changes in corporate governance and financial performance, and the results have been mixed. Studies show that the impact of more independent boards on financial performance has been notably weak.[116] That was the key finding of a recent study based on a large sample of firms over an extended period of time.[117] Broadening the base from independence on corporate boards to other criteria of corporate governance,

108. *See* Investor Responsibility Research Center Library, *supra* note 67; Institutional Shareholders Services, *supra* note 70.

109. *See* Governance Metrics International, *supra* note 74.

110. *See* Standard & Poor's, *supra* note 73.

111. Adam Lashinsky, *ISS Wants Business Both Ways*, FORTUNE, June 16, 2003, at 24.

112. *Id.*

113. *Id.*

114. Claire Hill, *Rating Agencies Behaving Badly*, 35 CONN. L. REV. 1145, 1145 (2003).

115. *Id.* at 1148.

116. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 IOWA J. CORP L. 231, 232-233 (2002).

117. *Id.*

however, reveals more positive results, especially in comparing the firms with the best governance systems versus those with the worst. Corporate governance experts Ira Millstein and Paul MacAvoy found that those companies rated A in their governance by the California Public Employees Retirement System outperformed those rated "F" by over 25 percent.[118]

*Business and Federalism Issues*

In the regulatory arena, there has been a lively debate over states' rights in the courts, and especially in the U.S. Supreme Court under Chief Justice Rehnquist's leadership. The tensions within our federal system of government have been important ever since the nation's founding, have assumed even more significance since the expansion of federal authority during the late New Deal years.[119] In the past ten years, there has been a rollback in federal authority and a resurgence of states' rights under the Rehnquist Court, also vigorously promoted by Justice O'Connor. Decisions like *U.S. v. Lopez*, ruling unconstitutional the Gun-free School Zones Act,[120] and *U.S. v. Morrison*, ruling unconstitutional the Violence Against Women Act,[121] have marked a new watershed on federalism issues. While the rollback in federal authority may please business in certain respects, the resulting promotion of more state regulation and activism may not be so pleasing. In fact, uniform regulation at the federal level, accompanied with a more rational and professional approach to regulation might prove easier for business to accommodate.

The rise in initiatives by state attorneys general and their aggressive pursuit of investigations and litigation against certain industries became more prevalent during the 1990s. The litigation by the states against the tobacco industry and against Microsoft are but two examples.[122] Most prominent starting since the year 2002 has been the action by New York Attorney General Eliot Spitzer versus the financial industry, relying on state laws like the Martin Act to prosecute leading investment banking firms.[123] Some conservatives and business interests have complained that he has invaded the legitimate turf of the Justice Department and SEC,[124] while Spitzer and his defenders respond that he was driven to act by the passivity and failure of the SEC under Chairman Harvey Pitt to act in a timely

118. Ira Millstein, & Paul MacAvoy, *The Active Board of Directors and Improved Performance or the Large Publicly Traded Corporation.* 98 COLUM. L. REV 1283, 1300 (1998).

119. ROBERT NAGEL, IMPLOSION OF AMERICAN FEDERALISM 5 (2001).

120. *See generally* U.S. v. Lopez, 514 U.S. 549 (1995).

121. *See generally* U.S. v. Morrison, 529 U.S. 598 (2000).

122. *See* CARRICK MOLLENKAMP, ET AL., THE PEOPLE VS. BIG TOBACCO: HOW THE STATES TOOK ON THE CIGARETTE GIANTS (1998); JOEL BRINKLEY & STEVE LOHR, U.S. V MICROSOFT: THE INSIDE STORY OF THE LANDMARK CASE (2000); Carolyn Mayer, *Attorneys General Crusade Against Corporate Misdeeds*, WASH. POST, Feb. 19, 2003, at E1.

123. Amy Borrus & Mike McNamee, *States vs. the SEC. What' all the Shouting For?* BUS. WK., July 28, 2003, at 39; Gary Weiss, *Competing Watchdogs Are Good for the Street*, BUS. WK., Sept. 1, 2003, at 86.

124. Brooke A. Masters, *States Role in Doubt on Wall Street*, WASH. POST, July 23, 2003, at E1.

manner.[125]

Congress and the U.S. Supreme Court do have the ability to override state initiatives through the doctrine of federal preemption.[126] While the Court has not always been sympathetic to claims of federal preemption, as in leading tobacco cases and occupational safety cases, it will usually defer to explicit statutory provisions of federal preemption.[127] This may provide an incentive for business to lobby for more such provisions in the future. While it may seem strange for business to advocate the expansion of federal power over the states, it may advance efficiency concerns for business while also boosting its public reputation for seeking constructive solutions. It may also curry favor with certain citizen groups who would join a coalition promoting federal power and regulation against old-guard conservative groups.

One major caveat is that the willingness of non-business interests to embrace federal pre-emption really depends on the stringency of the uniform federal standard to be applied. Bills proposed for uniform federal product liability standards have floundered for the past two decades because consumer groups and trial lawyers have objected to the more lenient standards of liability for business embodied in these bills, whether the issue is caps on punitive damages or standards for strict liability [128]

In the summer of 2003, House capital markets subcommittee Chairman Richard H. Baker (R-LA), proposed legislation to curb the power of state securities regulators and attorneys general,[129] perhaps to clip the wings of NY state attorney general Eliot Spitzer and his counterparts in other states. Baker and his supporters believe that securities markets should have only one watchdog, the SEC, and that states should not have the power to fashion remedies that change industry practices, and certainly not enforce rules tougher than those of the SEC.[130] SEC Chairman William Donaldson and Fed Chairman Alan Greenspan also seem to support that view.[131] Spitzer and his allies, however, aggressively lobbied against the bill, and it died in committee.[132] Given that Spitzer and the states have acted more swiftly against industry misconduct than have the SEC and the federal government, Wall Street firms supported Baker's initiative.[133] The criminal charges brought by Oklahoma State Attorney General Edmondson against

125. E.J. Dionne, *Defending States Rights Except on Wall Street*, WASH. POST, July 22, 2003, at A17.

126. U.S. CONST. art. I, § 8 (the Commerce Clause).

127. *See generally* U.S. v. Morrison, 529 U.S. 598 (2000); Cipollone v. Liggett Group, Inc., 505 U.S. 504 (1992); Lorillard Tobacco v. Reilly, 533 U.S. 525 (2001).

128. Lorraine Woellert, *Tort Reform: A Little Here, A Little There*, BUS. WK., Jan. 20, 2003, at 60.

129. Masters, *supra* note 124.

130. *Id.*

131. Brooke Masters & Ben White, *Donaldson Backs SEC Supremacy Bill*, WASH. POST, July, 16, 2003, at E1.

132. Ben White & Brooke Masters, *Bill to Limit State Probes of Wall St. Delayed*, WASH. POST, July 25, 2003, at E1.

133. *See* Masters, *supra* note 124; Borrus & McNamee, *supra* note 123.

WorldCom and four executives in August, 2003,[134] when the U.S. Department of Justice had thus far failed to act, again demonstrates the aggressive role the states sometimes play in the face of federal delays. The tension between the states and the federal government will certainly continue in the area of corporate financial fraud, as in many other areas.

Given the popularity of Spitzer's actions, the rise of state activism, and the tradition of state regulation of corporate governance, the Sarbanes-Oxley Act breaks new ground by pre-empting state law on corporate governance and absent the crisis of corporate scandals, surely would have generated much more controversy and debate. Of course, the U.S. House of Representatives was more resistant to the broad sweep of the law than was the Senate,[135] but on the heels of the WorldCom scandal, even Republicans in the House joined the throng supporting Sarbanes-Oxley.[136] The rather rapid passage of the law, however, should not obscure its major departure from past regulatory approaches. As one expert comments:

> For over 200 years, corporate governance has been a matter for state law. Even the vast expansion begun by the New Deal securities regulation laws left the internal affairs and governance of corporations to the states. Taken individually, each of Sarbanes-Oxley's provisions constitutes a significant preemption of state corporate law. Taken together, they constitute the most dramatic expansion of federal regulatory power over corporate governance since the New Deal.[137]

The law not only injects the SEC and the national listing exchanges into the regulation of the structure, composition, and duties of the corporate board, but it also regulates several aspects of executive compensation. Traditional federalism analysts believe that the states, as "laboratories of democracy, might generate better solutions through interstate competition, and that the one-size-fits-all approach of Sarbanes-Oxley is particularly inappropriate when trying to design governance models to fit different corporate cultures in vastly different industries.[138] Since Congress has moved so far on federalizing corporate law, it is perhaps less strange that even leading Republican legislators would now try to roll back state securities regulations and the power of state attorneys general. Perhaps those moves appease the efficiency interests of their business supporters, but they also move counter to the trends of recent Republican administrations and to the line of federalism decisions by the Rehnquist Court.

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134. Christopher Stern, et al., *Oklahoma Plans to Charge Ebbers, WorldCom*, WASH. POST, Aug. 27, 2003, at E1; Christopher Stern & Brooke Masters, *WorldCom, Ex-Officers Charged in Oklahoma*, WASH. POST, Aug. 28, 2003, at E1; Barnaby Feder and Kurt Eichenwald, *A State Pursues WorldCom and May Hurt the U.S. Case*, N.Y TIMES, Aug, 28, 2003, at C1.

135. Jackie Spinner, *Sarbanes Circulates Auditing Reform Bill*, WASH. POST, May 9, 2003, at A10.

136. Dana Milbank, *Both Political Parties Say Enron Proves Their Point*, WASH. POST, May 8, 2002, at A5.

137 Stephen Bainbridge, *The Creeping Federalization of Corporate Law*, REGULATION, Spring 2003, at 26

138. *Id.* at 30-31.

SARBANES-OXLEY ACT PROVISIONS

This section will first briefly state some of the leading provisions of the act[139] and then will elaborate on some contentious issues left open for regulation. The act provides for:

1 Public Accounting Oversight Board – with powers over the public accounting profession and independent audit firms: only firms registered with the board will be allowed to audit public companies; accountants must disclose any civil or criminal proceedings against them; the larges firms will be evaluated annually and smaller firms once every three years; in case of deficiencies, audit firms can be fined up to $15 million or barred entirely from public accounting.[140]

2. Auditor Independence – prohibits the provision of specified non-audit services, requires that permitted services be pre-approved by the corporate board, and requires that the lead audit partner be rotated every five years.[141]

3. Board of Directors Audit Committee – must be comprised only of independent directors and is responsible for the appointment, oversight, and compensation of company auditors.[142]

4. Certification of Periodic Financial Reports – the CEO and CFO must certify that financial statements fairly represent the issuer's financial condition and results of operations.[143]

5. Corporate Governance and Responsibility/Reimbursement of CEO/CFO Compensation – in the event of misconduct and misstated financial results, the CEO and CFO must repay any bonus, incentive compensation, or profits resulting there from.[144]

6. Insider Trades During Blackout Periods – directors and officers may not trade during blackout periods, and any resulting profits must be disgorged.[145]

7 Loans to Officers and Directors – issuers may not make any new loans or modify prior loans to their officers and directors.[146]

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139. Rules of Professional Responsibility for Attorneys (Sarbanes-Oxley Act), 15 U.S.C.S. § 7201 (2003) [hereinafter Sarbanes-Oxley Act].

140. Charles A. Bowsher, Statement before the Senate Banking Committee (Mar. 19, 2002) (transcript *available at* http://www.publicoversightboard.org/news_03_19_02.htm (last visited Mar. 3, 2004) (Charles Bowsher, at the time of this statement, was the chairman of the Public Oversight Board.); Sarbanes-Oxley Act, *supra* note 139.

141. Robert Reilly, *Summary of the Sarbanes-Oxley Act for Bankruptcy Appraisers*, 2003 AM. BANKR. INST. J. 40, 1-8 (2003). *See also* Sarbanes-Oxley Act, *supra* note 139.

142. Reilly, *supra* note 141.

143. *Id.*

144. *Id.*

145. *Id.*

146. *Id.*

8. Enhanced Financial Statement Disclosures – financial statements must reflect all material correcting adjustments identified by the company's auditors, and the SEC shall issue rules on the disclosure of off-balance-sheet transactions and the disclosure of pro forma financial results.[147]

9 Issuer and Management Disclosure/Insider Transactions – insider sales and purchases of stock must be reported within two days of the transaction.[148]

10. Other Issuer and Management Disclosures – the SEC must issue rules on the disclosure of a company's internal controls and financial reporting procedures, whether the company has a code of ethics and any waivers it allows, and whether the audit committee includes a financial expert.[149]

11 Fraud and Criminal Penalties – increases or adds criminal penalties for a number of securities and corporate governance matters, increases the statute of limitations, provides that debts arising from securities fraud cannot be discharged in bankruptcy, and authorizes the SEC to freeze any payments to officers and directors during investigations. For "knowingly" signing off on inaccurate financial statements, the penalty is up to ten years in jail and a $1 million fine, while for "knowingly and willingly" signing off on such statements, the penalty is up to tweny years in jail and a $5 million fine.[150]

12. SEC Resources and Authority – requires the SEC to issue rules regarding the minimum standards of professional conduct for attorneys practicing before the SEC.[151]

13. Securities Analysts and Securities Research Reports – requires the SEC to issue rules that address conflicts of interest of securities analysts.[152]

14. Regulatory Studies and Reports – authorizes the SEC, Comptroller General, and GAO to issue reports on the need for further legislation.[153]

15. Fraud and Criminal Penalties/Whistleblower Protections – creates protection for whistleblowers and employees when they act lawfully to disclose information about fraudulent activities in their companies.[154]

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147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.*, Jeremy Kahn, *A Taste of Success: But the Real Test for Sarbanes-Oxley is still ahead.* Fortune, Sept. 1, 2003, at 21.
151. Reilly, *supra* note 141.
152. *Id.*
153. *Id.*
154. *Id.*

16. Corporate Fraud Accountability – authorizes the SEC to prohibit "unfit" individuals from serving as officers or directors.[155]

*Auditor Conflicts of Interest*

According to Sarbanes-Oxley provisions, auditors are discouraged from providing a range of non-audit services to clients.[156] Those that are prohibited include human resources and technology services.[157] Tax projects must be approved by the client corporation's board, and the SEC has released guidelines stipulating that the approval must be for each project proposed and cannot be on a blanket basis.[158] In order to avoid the paperwork and processing costs that each pre-approval would entail, some firms may spread the work among various audit firms instead.[159]

*Regulation of Attorneys*

Since the passage of Sarbanes-Oxley, the SEC now requires attorneys to report any client misconduct upward in the organization as far as the board of directors, if necessary This is the so-called "reporting-up" or "laddering-up" provision.[160] More controversial has been its consideration of a "noisy withdrawal" provision, requiring that a corporate attorney resign from representing the firm and that the firm report any misconduct to the SEC.[161] In order to blunt this possible regulation, the American Bar Association narrowly approved an exception to the rule of attorney-client confidentiality which allows but does not require an attorney to go to the public authorities when company officials are violating the law in a way that harms the company [162] Attorneys are normally required to report violations of a client only when those violations pose physical harm to persons. The voluntary reporting standard follows the lead of forty-two states that already allow it.[163] In arguing in favor of the ABA's approach over that of a more rigid SEC noisy-withdrawal requirement, Bart Schwartz, general counsel to the Mony Group states, "The 'permissive reporting-out' rule approved by the ABA leaves more discretion to corporate lawyers about when it is necessary to divulge client confidences, and should give corporate clients more comfort that their lawyers can continue to handle sensitive information without turning into SEC informants."[164]

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155. *Id.*

156. Sarbanes-Oxley Act, *supra* note 139.

157. *Id.*

158. *Id.* at §§ h (regarding preapproval of non-audit services).

159. Carrie Johnson, *Tyco Auditor Barred from SEC Work*, WASH. POST, Aug. 14, 2003, at E1.

160. Sarbanes-Oxley Act, *supra* note 139.

161. *See* Brooke A. Masters, *ABA Eases Rule On Informing; Lawyers Can Now Report Suspected Fraud By Clients*, WASH. POST, Aug. 12, 2003, at E1 (The "noisy withdrawal" requirement is not contained in the statute itself but is subject to possible rule-making by the SEC.).

162. *Id.*

163. *Id.*

164. *Id.*

Prior to the ABA s action, the Washington state bar association was feuding with the SEC over the issue. It argued that complying with the SEC mandate would provide lawyers no protection from state bar sanctions for violating lawyer-client confidentiality [165] Citing Sarbanes-Oxley, the SEC argues to the contrary that federal rules should prevail over state rules.[166] The ABA's action, however, by making reporting outside the organization only voluntary, may have minimal impact in the face of such state bar codes. In California, for example, the state's Business and Professions Code provides for strict attorney-client confidentiality [167] On the other hand, if lawyers fail to exercise their option to report offenses to the SEC, they may be subject to shareholder lawsuits by injured investors.[168]

Expert assessments of the ABA's decision range from largely symbolic to "modest, as Columbia Professor Jack Coffee says,[169] to a "tectonic shift, as NYU Professor Stephen Gillers states.[170] Gillers states that the ABA "to its credit recognized that lawyers are in a public profession and have obligations to other people."[171] Coffee said the ABA amendments were "modest changes in the right direction, under the shadow of far more sweeping change that the SEC is considering this has real teeth, and the bar is scared to death about it."[172]

The ABA actually passed two amendments, one allowing lawyers to warn potential victims of fraud perpetrated by their clients, and the other allowing them to report the conduct.[173] In some states, codes of conduct already permit lawyers to report criminal conduct, and in most states, attorneys may warn victims of fraud if clients used the lawyers' legal work in conceiving the fraud.[174] The new ABA amendments and SOX oblige lawyers to report fraud to the board of directors and therefore go beyond the voluntary standard. The ABA standards go beyond Sarbanes-Oxley Act in one respect. They cover attorney obligations to private companies and nonprofit organizations such as unions, not just companies that report to the SEC.[175]

Part of the pressure being exercised on law firms to help expose white-collar crimes is also coming from the IRS. In its first action ever taken against a law firm, the IRS is taking action in federal court to force Jenkens & Gilchrist, a Dallas firm, to disclose details of a tax shelter plan the firm has allegedly marketed to a

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165. Brooke A. Masters, *New Rules Leave Lawyers In Bind on Whistle-Blowing*, WASH. POST, Aug. 6, 2003, at E1.

166. *Id.*

167 California Business & Professions Code, *available at* http://www.leginfo.ca.gov/.html/bpc_table_of_contents.html (last visited Mar. 11, 2004).

168. Myron Levin, *ABA Code Targets Corporate Crimes; The Lawyers Group Amends Ethic Standards to Encourage Attorneys to Report Wrongdoing*, L.A. TIMES, Aug. 13, 2003, at 1.

169. *Id.*

170. *Id.*

171. *Id.*

172. *Id.*

173. *Id*

174. *Id.*

175. *Id.*

client.[176] Here again, the concern is violation of the attorney-client privilege.

Regarding the rights of investors to bring private lawsuits against law firms, the SEC has banned them from doing so unless they can show the firms are "primary actors" causing their losses.[177] Senator Christopher Dodd (D-CT) and others inserted that dubious provision as part of the Securities Litigation Reform Act of 1995.[178] Nonetheless, investors are trying to hold liable the firms of Kirkland & Ellis and Milbank, Tweed, attorneys for various Enron entities and investment bankers.

### COMBINATION OF REGULATIONS AND SELF-REGULATION

There are several cases where agencies, both government and self-regulatory bodies, have concurrent jurisdiction over an industry, sector, or issue. This is no truer than in regulations of the financial sector. The Freddie Mac case is a good example where different agencies have jurisdiction and have taken action. In this case, the SEC, Department of Justice, and the Office of Housing Enterprise Oversight, the agency established to specifically regulate Fannie Mae and Freddie Mac, have all been involved.[179] Freddie Mac is being investigated for violating SFAS 133, a rule passed in January 2001 to require companies to value at current market prices its derivatives contracts.[180] Freddie Mac instead sought to actually understate current earnings, in contrast to all the other earnings restatement cases, in order to smooth out earnings projections over the long term and avoid the appearance of volatility [181]

In the aftermath of the WorldCom collapse, even more government agencies and authorities have assumed important roles. The SEC investigated the accounting fraud and came to a $500 million settlement with the company [182] The Justice Department is prosecuting several former WorldCom executives for criminal violations.[183] The Department of Justice and the Federal Communications Commission are both investigating charges, including illegal rerouting of calls, made by the firm's competitors.[184] The General Services Administration (GSA) has ordered that WorldCom should not be able to compete for government

176. Albert B. Crenshaw, *IRS Case Tests Attorney-Client Privilege*, WASH. POST, Aug. 15, 2003, at E3.

177 Steven Pearlstein, *Not So Firm With Lawyers*, WASH. POST, Aug. 13, 2003, at E1.

178. *Id.*

179. Kathleen Day & David S. Hilzenrath, *Stock Sales Followed 'Smoothing Freddie Mac Chief Cleared $17* Million, WASH. POST, Aug. 16, 2003, at A1.

180. *Id.*

181. *Id.*

182. Seth Schiesel, *WorldCom Seems Close to Deal to Settle SEC's Fraud Case*, N.Y TIMES, Nov. 5, 2002, at C1, *See also* Jerry Knight, *WorldCom Stockholders Owe SEC Thanks for Almost Nothing*, WASH. POST, May 26, 2003, at E1.

183. Christopher Stern, *New Charges Brought Against CFO at WorldCom*, WASH. POST, April 17, 2003, at E1.

184. Christopher Stern, *FCC Opens Probe Into WorldCom Access-Fee Allegations*, WASH. POST, July 31, 2003, at E2; *see also* Christopher Stern & Brooke A. Masters, *U.S. Probes WorldCom on Evading Access Fees*, WASH. POST, July 27, 2003, at A1.

contracts, but Congress can always make a different determination.[185] Politics could make a big difference here for WorldCom since the Federal Government is a major customer and depends heavily on the company WorldCom's major competitors, especially Verizon and AT&T however, also have political clout in Congress and have been generous campaign donors.[186] Finally, WorldCom is also accountable to a bankruptcy court, which will take into account two investigations of the firm's collapse, one report authorized by the board and the other by the court itself.[187] That investigation, supervised by former Attorney General Richard Thornburgh concluded, among other things, that "[i]t appears that the Company's officers and Directors went along with Mr. Ebbers and Mr. Sullivan, even under circumstances that suggested corporate actions were at best imprudent and at worst inappropriate."[188] WorldCom had concocted an $11 billion accounting fraud, involving the blatant violation of classifying operating expenses as capital costs,[189] which should have set off alarm bells for an engaged board and audit committee.

The National Association of Securities Dealers (NASD) will also sometimes join regulatory bodies in bringing suit or other action against alleged violators. In one celebrated case, the NASD has filed suit against Frank Quattrone, former research director and investment banker for Credit Suisse First Boston for failing to supervise stock analysts, for undermining their independence by tying their bonuses to banking fees generated, and for spinning IPOs to investment banking clients.[190] Subsequently, the Manhattan U.S. Attorney launched a criminal investigation for obstruction of justice by Quattrone, for ordering employees to purge emails after an investigation had been launched, and may prosecute following an initial mistrial. The SEC is also involved in the investigation.[191]

Multiple agencies and authorities have also been involved in the various investigations and charges brought against Enron and its executives. The SEC and federal prosecutors have brought various civil and criminal charges.[192] The

185. Yuri Noguchi, *WorldCom Appoints Roscitt as President: Former AT&T Executive Faces Tough Rebuilding Challenge*, WASH. POST, Aug. 13, 2003, at E1.

186. Christopher Stern, *SBC Accused WorldCom in '02; Regional Phone Company Said It Was Shortchanged*, WASH. POST, July 29, 2003, at E1; *See also* Christopher Stein, *Verizon Backs Ending U.S.-WorldCom Deals*, WASH. POST, July 28, 2003, at E1.

187 Griff Witte & Brooke A. Masters, *WorldCom Creditors Agree to Suspend Routing Probe*, WASH. POST, Sept. 5, 2003, at E1; Jonathan D. Glater, *WorldCom Hearing Starts, Then Stops for More Talks*, N.Y TIMES, Sept. 9, 2003, at C4; Kenneth N. Gilpin, *WorldCom and Dissident Creditors Settle on Payment Plan*, N.Y TIMES, Sept. 9, 2003, *available at* http://www.nytimes.com (last visited Feb. 16, 2004); *see also* Jonathan D. Glater, *WorldCom Agrees on Deal to Satisfy More Creditors*, N.Y TIMES, Sept. 10, 2003, at C1.

188. Christopher Stern, *Two Reports Fault Founder on WorldCom Operation: Atmosphere Allowed Deception, Probes Say*, WASH. POST, June 10, 2003, at A1.

189. Christopher Stern & Brooke A. Masters, *WorldCom, Ex-Officers Charged in Oklahoma: U.S. Prosecutors Say Move Could Hurt Federal Case*, WASH. POST, Aug. 28, 2003, at E1. *See also* Christopher Stern, *WorldCom Writes Off $80 Billion in Assets: Value of Acquisition, Network Has Declined*, WASH. POST, Mar. 14, 2003, at E1.

190. Gretchen Morgenson, *Suit Expected Against Star of First Boston*, WASH. POST, Feb. 1, 2003, at 1.

191. Brooke Masters, *Quattrone Charged in Probe of CSFB*, WASH. POST, Mar. 7, 2003, at E4.

192. Kurt Eichenwald, *Fraud Charges Filed Against 2 Employees of Enron Unit*, N.Y TIMES, Mar.

Federal Energy Regulatory Commission has investigated Enron's manipulation of the California energy market.[193] Further, the Commodity Futures Trading Commission has charged Enron and two executives with manipulating natural gas and agricultural commodity prices.[194]

*Exchange Rules.* Beyond the combination of government rules and regulations are the rules established by the NYSE and Nasdaq that must meet with SEC approval. According to major legal expert Jack Coffee, it is the history and effectiveness of the private self-regulatory organizations, not state intervention or supervision that has built confidence in the integrity of the financial markets.[195] The NYSE requires that all listed companies have a majority of outside directors and that the audit and compensation committees be composed entirely of independent directors.[196] The NYSE is also tightening its definition of "independent, excluding those with a "material relationship" to the firm, and is requiring non-management directors to meet in executive sessions.[197] The Nasdaq offered parallel rules in advance of Sarbanes Oxley and also requires that an audit committee of independent directors hire and fire the firm's auditor. While the NYSE has never delisted a company for governance reasons, of the 670 companies delisted by Nasdaq over 2001-02, 100 were delisted for reasons related to corporate governance.[198]

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13, 2003, at C1; Peter Behr & Carrie Johnson, *More Enron Charges Expected Today: Fastow Wife, Executives in Broadband Unit Are Latest Targets*, WASH. POST, May 1, 2003, at E2; Nancy R. Brooks, *FBI Arrests Former Enron Energy Trader John Forney, Who Is Accused of Drafting Many of the Firm Schemes, Is Charged with Fraud, Conspiracy*, L. A. TIMES, June 4, 2003, at 1; Kurt Eichenwald, *Second Enron Energy Trader Pleads Guilty*, N.Y TIMES, Feb. 5, 2003, at C2; Peter Behr & Carrie Johnson, *Second Tier Key to Enron Case: Prosecutors Push Skilling Lieutenants*, WASH. POST, Nov. 30, 2002, at E1; Peter Behr & Carrie Johnson, *Executives Resist Enron Prosecutors: Government Falls to Get Testimony From Some High-Ranking Insiders*, WASH. POST, Dec. 28, 2002, at E1; Kurt Eichenwald, *Three British Bankers Are Accused of Fraud in Offshoot of Enron Case*, N.Y TIMES, June 28, 2002, at C1; Kurt Eichenwald, *U.S. Said to Warn Six Ex-Enron Executives Over Charges*, N.Y TIMES, April 28, 2003, at C2; Floyd Norris, *A Warning Shot to Banks on Role in Others Fraud*, N.Y TIMES, July 29, 2003, at C1; Kurt Eichenwald, *Two Banks Settle Accusations They Aided in Enron Fraud*, N.Y TIMES, July 29, 2003, at A1; Ben White & Peter Behr, *Citigroup, J.P Morgan Settle Over Enron Deals*, WASH. POST, July 29, 2003, at A1. *See also* James V Grimaldi, *Justice Rejected IRS Call for Enron Probe*, WASH. POST, July 29, 2003, at E1.

193. Alex Berenson, *Mystery of Enron and California Power Crisis*, N.Y TIMES, May 9, 2002, *available at* http://foi.missouri.edu/usenergypolicies/mystenron.html (last visited Feb. 16, 2004); Richard Simon, Ricardo Alonso-Zaldivar & Tim Reiterman, *Enron Memos Prompt Calls for a Wider Investigation; Electricity: Regulators Order All Energy Trading Companies to Preserve Documents on Tactics*, L.A. TIMES, May 8, 2002, at A1; Kenneth Bredemeier, *Memo Warned of Enron Calif. Strategy; West Coast Senators Complain About Market Manipulation During Power Crisis*, WASH. POST, May 16, 2002, at A4.

194. Richard A. Oppel, *Enron Many Strands: The Strategies: How Enron Got California to Buy Power It Didn't Need*, N.Y TIMES, May 8, 2002, at C1; *see also* Peter Behr, *U.S. Files New Enron Complaints: Former Officers Cited for Web, Trading Deals*, WASH. POST, Mar. 13, 2003, at E1.

195. John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1 (2001).

196. Ben White, *NYSE, Nasdaq Face Test Living Up to Tough Talk: New Rules Proposed, But Doubts Remain*, WASH. POST, Jan. 21, 2003, at E1.

197. *Id.*

198. *Id.*

The NYSE, along with the SEC, is also promoting the interests of disclosure to investors. In one area, it has backed off due to First Amendment concerns. The NYSE had considered prohibiting Wall Street analysts from speaking with media outlets that failed to disclose any potential conflicts of interest for analysts being interviewed. Though disclosure of such conflicts might be important information for investors, it did not justify the prior restraint on analyst speech.[199]

## REMEDIES

The complex area of legal remedies involves a large range of issues and choices: litigation versus arbitration, government versus private action, civil versus criminal sanctions, and personal versus corporate liability The issue is also directly connected to that of legal jurisdiction, that of the specific agency or agencies involved, and whether a case can be brought by state or federal authorities, or both. The sanctions differ from one agency to another and from one level of government to another. Among the most significant issues, and perhaps the primary one, is whether the government ought to pursue individual violators or entire firms, whether they be corporations or audit firms.

*Individual versus Corporate Liability:* There is less dispute over the wisdom of criminally prosecuting individual wrongdoers than over prosecuting corporations. The controversy surrounding the prosecution and demise of Arthur Andersen is a leading example of that dispute. To convict an organization also still requires that an individual perpetrator be identified, and then a jury can hold the organization vicariously liable. Some of the legal controversy surrounding the guilty verdict of Andersen was the judge's ruling that different jurors could find different executives, rather than the same one, guilty in order to hold the firm liable.[200] The larger practical criticism is that entire firms, and many innocent parties, are punished for the sins of perhaps just a few when firms are held liable.[201] However, others argue that it is entirely appropriate to prosecute a firm when its culture is that of a repeat offender or chronic violator, even if the firm's

199. Alex Berenson, *A U.S. Push on Accounting Fraud*, N.Y TIMES, April 9, 2003, *available at* http://securities.stanford.edu/news-archive/2003/20030409_Headline11_Berenson.htm (last visited Mar. 2, 2004); *N.Y.S.E Abandons Gag Plan*, N.Y. TIMES, April 4, 2003, *available at* http://securities.stanford.
edu/news-archive/2003/20030409_Headline11_Berenson.htm (last visited Mar. 2, 2004).

200. Stephen Gillers, *The Flaw in the Andersen Verdict*, N.Y TIMES, June 18, 2002, at A23; Carrie Johnson, *Andersen Jury Hints at Cause of Indecision: Note Asks About Individuals Roles*, WASH. POST, June 14, 2002, at E1; Kirstin D. Grimsley & Jackie Spinner, *Some Call Andersen Verdict Irrelevant: In Accounting Industry, Firm Viewed as Already 'Mortally Wounded'* WASH. POST, June 15, 2002, at E1; *Andersen Judge Rules Calamitous Court*, WASH. POST, June 6, 2003; Carrie Johnson, *Andersen May Ask Judge to Overturn Conviction*, WASH. POST, June 20, 2002, at E3.

201. J.M. Holcomb & S.P Sethi, *Corporate and Executive Criminal Liability: Appropriate Standards, Remedies, and Managerial Responses*, 4 BUS. & CONTEMP WORLD 81, 81-105 (1992). *See* Ann Davis, *Executives on Trial: Enron Heat Descends on Smaller Prayers; Others Enjoy Shade*, WALL ST. J., Dec. 1, 2003, at C1. *See also* Kristen Hays, *Enron Schemes Reflect Culture, Report' Author*, L.A. TIMES, Feb. 10, 2003, at 3.

existence is placed in jeopardy [202]

Though the tide may be turning more in favor of prosecuting organizations, the SEC has focused to date mainly on individual auditors and accountants, and the Andersen case was brought by the Department of Justice, not by the SEC.[203] Further, among its legal actions, the SEC has focused almost entirely on small accounting firms and brought charges in 2002 against only two auditors working for then Big 5 firms, while bringing actions against auditors from 15 auditors from smaller firms.[204] The disciplinary actions brought against smaller firms are more often for incompetence, while the actions brought against the large firms are for lapses of integrity [205] In total, it brought 598 enforcement actions in 2002, up 24 percent from the previous year.[206]

One example of the action taken by the SEC against individual auditors was a case involving PricewaterhouseCoopers (PwC), once the lead auditor for Microstrategy, a company whose "accounting mirage" and inflated earnings is credited for bursting the tech bubble,[207] even before subsequent scandals at Enron and WorldCom surfaced. In this case, the individual auditor was barred from auditing publicly traded companies for a two-year period and can then apply for reinstatement with the SEC. The SEC took a similar approach in penalizing an audit partner with PwC who was "reckless" in auditing Tyco and ignoring signs of trouble.[208] In neither case, though, did the SEC take any action against PwC as a firm. PwC also paid $50 million to settle a lawsuit with Microstrategy investors who charged the firm for defrauding them by approving the company's books.[209] The shareholders' report also charged that PwC and Microstrategy had discussed joint business deals, jeopardizing PwC's independence and creating a conflict of interest.[210]

In 2002, the SEC did bring administrative charges against Ernst & Young for violating independence rules by a joint marketing arrangement with client company PeopleSoft.[211] Words by Enforcement Director Stephen Cutler indicate

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202. *Id.*, *see generally* BARBARA L. TOFFLER & JENNIFER REINGOLD, FINAL ACCOUNTING: AMBITION, GREED AND THE FALL OF ARTHUR ANDERSEN (2003); BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM (2003); *see also* SHERRON WATKINS & MIMI SWARTZ, POWER FAILURE: THE INSIDE STORY OF THE COLLAPSE OF ENRON (2003).

203. *U.S. v. Arthur Anderson*, LLP Crim. CRH-02-121, (Tex. S. Dist. Ct., Mar. 7, 2002), *available at* http://news.findlaw.com/hdocs/enron/usand50202gopp2gjdoc.pdf (last visited Feb. 16, 2004).

204. David S. Hilzenrath, *Big Firms Avoiding SEC Ire; Enforcement Record Lopsided,* WASH. POST, Jan. 17, 2003, at E1; Paula Dwyer, *The Big Four· Too Few to Fail?* BUS. WEEK, Sept. 1, 2003, *available at* http://www.businessweek.com/@@atkRB4UQxg*p9BQA/magazine/content/03_35/b3847033.htm (last visited Feb. 16, 2004). *See also* Carrie Johnson & Brooke A. Masters, *Prosecutors, Regulators Step Up Pace of Auditor Probes,* WASH. POST, Jan. 28, 2003, at E1.

205. Hilzenrath, *supra* note 204.

206. *Id.*

207 David S. Hilzenrath, *SEC Settles Case with Audit Firm,* WASH. POST, Aug. 18, 2003, at E1.

208. Carrie Johnson, *SEC Prods Boards on Work for Auditors,* WASH. POST, Aug. 14, 2003, at E2.

209. Hilzenrath, *supra* note 207.

210. *Id.*

211. *Id.*

that the SEC may bring more actions against the audit firms in the future. He has stated:

> In short, absent egregious conduct, in which senior firm managers participated or acquiesced, the commission typically has elected not to pursue a case against the firm itself. It is time to adopt a new enforcement model a new paradigm: one that holds an accounting firm responsible for the actions of its partners; one that reverses the current presumption against suing firms for an audit failure.[212]

In the wake of the criminal prosecution and subsequent demise of Arthur Andersen, however, there is one major factor that inhibits the government from bringing criminal charges against the organization. Should it do so and cause the downfall of yet another major accounting firm, the industry becomes even more concentrated. The "big five" that has dwindled to the "big four" risk becoming the "big three." Given its criminal jurisdiction, the Justice Department is thwarted more than the SEC by this factor. By shrinking the number of major firms, it also would make even more difficult the rotation of audit firms, discussed later in this article. Hence, the major accounting firms may be politically insulated from further criminal prosecution and, in a sense, may have become too big to fail. Businesses now audited by the big four accounting firms account for a huge 99 percent of all public company sales, about which SEC Chairman William Donaldson says, "It's a national problem. We're concerned about the long-term implications. [213] To combat such industry concentration, the government could award more contracts to non-big-four firms and to foreign accounting firms.

When the government seeks to hold firms and organizations liable, there are lessons that the Arthur Andersen case teaches, most importantly that such a firm must cooperate fully with the government. Firms will be rewarded for cooperation and punished dearly for resistance and confrontation. As one leading observer put it, "[t]ime and time again the firm made missteps that left prosecutors questioning its desire to resolve the case. Its efforts at internal change went nowhere, as the partnership spun into chaos. When its lawyers suggested that Andersen consider pleading guilty the firm's management replaced them."[214]

There have been stiffer organizational sanctions permitted under recent changes to the U.S. Sentencing Guidelines, giving the prosecution more leverage and making cooperation with the government more compelling.[215] This is further related to the new regulations of attorney obligations under Sarbanes-Oxley Not only are attorneys given a greater incentive to report management misconduct upward, but the firms themselves are given incentive to waive any privilege, under

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212. *Id.*

213. Dwyer, *supra* note 204.

214. Kurt Eichenwald, *Miscues, Missteps, and the Fall of Andersen*, N.Y TIMES, May 8, 2002, at C1.

215. News Release, U.S. Sentencing Commission, Sentencing Commission Stiffens Penalties for White Collar Criminals (Jan. 8, 2003), *at* http://www.ussc.gov/PRESS/rel010803.htm (last visited Mar. 11, 2004).

Justice Department policies.[216] The law thus encourages cooperation in various ways, and individual employees must beware that their own personal interests that weigh in the balance may be sacrificed by the firm. When the firm is rewarded for cooperation, an employee can even be fired for asserting her legal freedom from self-incrimination under the Fifth Amendment. That has been one of the potential consequences even as firms have sought to mitigate their sentences since the organizational sentencing guidelines were passed in 1990.[217]

*Civil versus Criminal Liability:* While it has been less common for the government to seek criminal penalties against auditors, aside from the obstruction of justice prosecution of Arthur Andersen, it is becoming more common to seek such penalties against executives in the scandal-ridden firms. Three former Tyco executives, for example, have been charged with criminal offenses, and one of its board members has pleaded guilty to securities fraud.[218]

The enhanced criminal penalties under Sarbanes-Oxley are also proving to be an effective lever in building cases against violators at the top. The Justice Department and SEC combine forces to investigate corporate fraud, and as at companies like HealthSouth and Symbol Technologies, have pursued indictments of mid-level and senior managers to gather evidence against those at the top.[219] With the tougher penalties, lower level managers have a greater incentive to cooperate with the government to lighten their sentences. Still, some take a different view. Some defense lawyers believe that the penalties are too harsh and with more at stake, clients will actually be less willing to talk.[220] Whatever provided the incentive, nine HealthSouth executives, including three top finance officers, have pleaded guilty to criminal charges in the case involving $2.5 billion of overstated profits.[221]

In the complex Enron case, federal prosecutors have indicted Andrew Fastow on 78 counts and received a guilty plea from his deputy Michael Kopper.[222] The government has also brought criminal fraud charges against two other Enron executives for trying to hide the Braveheart internet video venture off the books while it failed to meet the rule of having a minimum of 3 percent of its capital from outside investors.[223] The essence of the fraud is that "Enron sold its interest in broadband to itself but pretended that there were outside investors with capital at risk to make the transaction appear to be a true sale."[224]

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216. Lorraine Woellert, *How Much Can You Still Tell Your Lawyer?* BUS. WEEK, Sept. 1, 2003, at 52.

217 Holcomb & Sethi, *supra* note 201; *See also* J. Moore, J, *Corporate Culpability Under the Federal Sentencing Guidelines, in* TOM L. BEAUCHAMP & NORMAN E. BOWIE, ETHICAL THEORY AND BUSINESS 99-109 (2000).

218. Carrie Johnson, *Tyco Auditor Barred from SEC Work,* WASH. POST, Aug. 14, 2003, at E1.

219. Alex Berenson, *A U.S. Push on Accounting Fraud,* N.Y. TIMES, April 9, 2003, at C1.

220. *Id.*, *See also* Christopher Stein, *SEC, WorldCom Say Settlement Is Just,* WASH. POST, June 12, 2003, at E5.

221. *The Ex-Bosses Fight Back,* ECONOMIST, April 12, 2003, at 56-57

222. Behr & Johnson, *More Enron Charges Expected Today, supra* note 192.

223. Eichenwald, *Fraud Charges Filed Against 2 Employees of Enron Unit, supra* note 192.

224. *Id.*

Civil fines and remedies can result from either court proceedings or administrative settlements. The SEC pursued administrative action against Deutsche Bank AG for failing to disclose a conflict of interest in voting its shares in favor of Hewlett Packard's (H-P) acquisition of Compaq Computer Corp.[225] The Bank had business deals with H-P with more to follow were the acquisition approved.[226] The forces supporting William Hewlett's opposition to the deal accused H-P of buying the bank's vote. For its failure to disclose, the bank agreed to pay $750,000, and the SEC also censured the firm and directed it to cease and desist from further securities violations.[227]

The largest settlement ever was negotiated by the SEC with WorldCom, on behalf of investors. WorldCom recently settled for $500 million with victimized stock and bond holders, and fraud victims will also receive $250 million worth of stock in the reorganized company, when it emerges from bankruptcy.[228] Shareholders are normally last in line to be paid in bankruptcy proceedings, so critics of the settlement observe that bondholders who normally receive higher priority will be subsidizing shareholders through the settlement.[229] The Sarbanes-Oxley Act at least has made possible the ability to pay victims.[230] Prior to the law, settlement money would have been paid to the U.S. Treasury.[231] The penalty is the largest ever paid by a non-Wall Street firm but is slight compared to the $180 billion in damage done to investors.[232] WorldCom has also taken some measures of internal reform, having replaced its entire board of directors and removed more than two dozen executives who were directly or indirectly involved in the company's accounting problems. More on the WorldCom internal reforms is discussed below. There is serious question whether WorldCom has been sufficiently punished by its settlement with the SEC, and some argue it should be liquidated rather than allowed to reorganize under bankruptcy.[233] Given that WorldCom's collapse wiped out around $180 billion in shareholder value,[234] many competitors and critics argue the settlement is totally inadequate, even though it is

225. Ariana E. Cha, *Deutsche Bank Pays $750,000 in SEC Settlement*, WASH. POST, Aug. 20, 2003, at E1.

226. *Id.*

227. *Id.*

228. Jonathan D. Glater, *WorldCom Agrees on Deal to Satisfy More Creditors*, N.Y TIMES, Sept. 10, 2003, at C1. *See also* Gilpin, *supra* note 187

229. Glater, *supra* note 228. *See also* Jerry Knight, *WorldCom Stockholders Owe SEC Thanks for Almost Nothing*, WASH. POST, May 26, 2003, at E1.

230. Christopher Stern, *WorldCom Settlement Approved by Judge: Stock and Bond Holders to Get $750 Million in Civil Fraud Case*, WASH. POST, Aug. 7, 2003, at E1.

231. *Id.*

232. Christopher Stern, *WorldCom Settlement Passes Key Judicial Test*, WASH. POST, July 8, 2003, at A1. *See also* Johnathan Krim, *No Easy Road Ahead at WorldCom; Analysts Say that Troubles in Telecom may Prove Hard to Overcome*, WASH. POST, June 10, 2003, at E1; Christopher Stern, *WorldCom Picks New Directors; Firm Distancing Itself from Former Leaders*, WASH. POST, Aug. 30, 2003, at E1.

233. Jerry Knight, *WorldCom Stockholders Owe SEC Thanks for Almost Nothing*, WASH. POST, May 26, 2003, at E1.

234. *Id.*

the largest ever negotiated by the SEC.[235] Some suggest the government wanted WorldCom to emerge from bankruptcy and to survive as it now has under the MCI label, rather than face liquidation, for a number of reasons – to prevent any adverse impact on its 55,000 employees and the economy, to maintain its vital supplies of data equipment to the government and defense department, and to preserve competition in the telecommunications industry to serve antitrust values.[236]

The SEC has also settled its civil charges against J.P Morgan Chase and Citigroup for helping Enron "cook the books."[237] In announcing the $300 million settlement, enforcement director Stephen M. Cutler sent a message to all other financial institutions that might have facilitated fraud at other firms under investigation, such as Freddie Mac, WorldCom, and AOL Time Warner. Cutler stated, "If you know or have reason to know that you are helping a company mislead its investors, you are in violation of the federal securities laws."[238]

Corporate critics see the settlement as much too insignificant in contrast to the damage the banks facilitated at Enron. As William Greider states:

> The $300 million Enron 'settlement' government regulators worked out with the nation's two largest banks smells so bad that even *The Wall Street Journal* editorial writers gagged on the rank odor. What Citigroup and JP Morgan Chase did, remember, was to design the funny-money financial deals that directly pumped up Enron's profits and stock price. When Enron's fraudulent scheme unraveled and the stock collapsed, the nation's pension funds lost somewhere between $25 to $50 billion. And these two famous banks each profited mightily from their role as financial architects of the great swindle. The pay-up costs will not even require an asterisk on their balance sheets.[239]

Not just corporate critics like Greider weighed in against the settlement, but so did *Business Week* magazine. While acknowledging the difficulty of demonstrating willful fraud necessary to bring criminal charges, the amount of $300 million would be seen as merely a cost of doing business, since the fines represent "roughly a week's profit to the banks."[240] Especially since Sarbanes-Oxley allows some of the fines to be credited against liability under private securities litigation, authority Jack Coffee concludes, "I don't think there was

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235. *Id.*

236. Stephanie N. Mehta, *Well Connected; Why is Washington So Determined to Save WorldCom*, FORTUNE, June 9, 2003, at 40; *see also* Christopher Stern, *WorldCom Wins New Federal Contract*, WASH. POST, July 19, 2003, at E2.

237 Ben White and Peter Behr, *Citigroup, J.P Morgan Settle over Enron Deals*, WASH. POST, July 29, 2003, at A1. *See also* Eichenwald, *Two Banks Settle Accusations They Aided in Enron Fraud, supra* note 162.

238. Jerry Knight, *Look Out, Aiders and Abettors*, WASH. POST, Aug. 4, 2003, at E1.

239. William Greider, *Crooks off the Hook*, TOMPAINE.COM, Aug. 7, 2003, *at* http://www.tompaine.
com/feature2.cfm/ID/8568 (last visited Feb. 16, 2004).

240. Emily Thornton and Mike France, *For Enron Bankers, a "Get Out of Jail Free Card*, BUS. WEEK,Aug. 11, 2003, at 29.

deterrence in these settlements."[241]

*Fines versus Action Remedies:* Even in civil cases, courts and especially regulatory agencies have the option of imposing financial penalties or action-forcing remedies, or both. The common complaint about fines or financial settlements is that they are usually passed on to shareholders, or sometimes to customers in the form of higher prices.[242] The pain may not be borne by the actual perpetrators, unless the penalties are so heavy that the firm or its board takes action against the offending officers or employees. Action remedies, however, may include pain directly inflicted on the individual offender. For instance, the SEC may bar auditors from auditing publicly-traded companies and may even bar executives from serving as officers or directors of a listed company [243] In the year 2000, the SEC barred thirty-eight executives from ever again serving as officers or directors of public companies, and in the first two thirds of 2003, that number had increased to 105, including two WorldCom financial executives.[244] The SEC has brought legal charges against two former executives from Merrill Lynch for aiding and abetting securities fraud at Enron for moving Nigerian ships off the books through a sham sale and for fraudulent energy trades.[245] In addition to fines and injunctions, the SEC is seeking a permanent ban to prevent the executives from serving as officers or directors of any listed company [246] The SEC has targeted for a similar fate executives with Qwest, HealthSouth, and Tyco.[247]

Not only can the SEC bar executives from future corporate positions, but so can the NASD. In the case against Frank Quattrone mentioned above, the NASD is seeking to bar Quattrone from the securities industry for failing to cooperate with the investigation.[248] The NASD also brought a different type of action-forcing remedy against the brokerage firm Hornblower & Weeks, suspending it from publishing research for six months, since it had published "misleading and exaggerated statements" about a stock.[249] Other government agencies besides the

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241. *Id.*

242. Holcomb and Sethi, *supra* note 171.

243. Amy Borrus & Mike NcNamee, *Go Ahead, Make the SEC' Day*, BUS. WEEK, June 2, 2003, at 27.

244. *Id.*

245. Carrie Johnson, *SEC Accuses Four Former Executives at Merrill of Aiding Enron Fraud*, WASH. POST, Mar.
18, 2003, at E1,

246. *Id.*

247. Carrie Johnson, *Tyco Auditor Barred from SEC Work: PricewaterhouseCoopers Partner said to have*
*Ignored Signs*, WASH. POST, Aug. 14, 2003 at E1. *See also* Christopher Stern, *U.S. Charges Eight in Qwest Fraud Probes*, WASH. POST, Feb. 26, 2003, at E1.

248. Walter Hamilton, *NASD Regulators Charge Quattrone; Investment Banker is Accused of 'Spinning*
*Coveted IPO Shares and Improper Oversight of Stock Analysis*, L.A. TIMES, Mar. 7, 2003, at B2; *see also* Brooke A. Masters, *Former Tech Banker Quattrone Indicted; Obstruction of Justice Alleged*, WASH. POST, May 13, 2003, at E4; Brooke A. Masters, *Quattrone Charged in Probe of CSFB; NASD Cites IPO Trades for Business*, WASH. POST, Mar. 7, 2003, at E4.

249. Patrick McGeehan, *For Financial Firms, Proposed New Rules on Analysts are the Least of Their Problems*, N.Y TIMES, May 8, 2002, at C2.

SEC can at least remove executives from their present positions, or urge their boards to do so. In the case of Freddie Mac, the OHEO agency ordered that two executives, the president and general counsel, be removed from the company,[250] after the board had already terminated the previous CEO and two other officers and restated earnings of $4.5 billion for the past three years.[251]

When fines are the remedy, the question arises what level of fine is appropriate and effective. Citigroup Global Markets, formerly Salomon Smith Barney, was fined only $1 million by the NYSE for failing to give suitable advice to WorldCom employees related to their pension holdings in company stock.[252] Salomon Smith Barney had advised the employees to borrow money to pay taxes resulting from the exercise of stock options, rather than cash in the options.[253] That level of fine is less than a slap on the wrist.

*Private Lawsuits:* Perhaps the most expensive remedy for any offending firm is that of private lawsuits brought by injured parties. In the many cases of corporate scandals, those injured parties are usually employees, retirees, or investors. The pension funds and institutional investors are often a greater threat than regulatory agencies, regarding the amount of damages they can extract from corporate offenders. The 1995 Securities Litigation Reform Act, meant to limit liability to shareholders, also gave institutional investors higher priority as lead plaintiffs in securities cases.[254] The University of California system, with its $145 million in losses following the Enron debacle, is the lead plaintiff in a class-action suit against Enron and all of its financial backers.[255] The pension funds of Ohio and California are suing AOL Time Warner for over $100 million in losses to their state pension funds.[256] Ohio and West Virginia pension funds are also suing Freddie Mac and three former executives for securities fraud, causing almost $30 million in stock losses to those states.[257] Ohio also has suits pending against Enron, WorldCom, and Global Crossing.[258] The California Public Employees' Retirement System (CALPERS) estimates it lost $565 million on its WorldCom investments, while the New York State Common Retirement Fund lost about $300 million.[259] Those pension funds are also bringing suits against the company The

250. Jonathan D. Glater, *Freddie Mac Board Forced to Remove Chief Executive*, N.Y TIMES, Aug. 23, 2003, at C1. *See also* Kathleen Day, *Freddie Mac Board Told to Remove CEO; Regulators Cite Parseghian Role in Improper Accounting; Directors Response is Unclear* WASH. POST, Aug. 22, 2003, at E01.

251. *See* Carrie Johnson and Kathleen Day, *Freddie Mac Ousts Three Top Executives; Shake-up at Mortgage Giant Roils Markets*, WASH. POST, June 10, 2003, at A1 (discussing the earlier action by the Freddie Mac board and the actions by top officer that lead to the board's actions).

252. Christopher Stern, *Citigroup Fined for WorldCom Advice: NYSE Says Workers Were not Warned*, WASH. POST, Aug. 23, 2003, at E1.

253. *Id.*

254. Jackie Spinner, *Pension Funds Sue Freddie Mac*, WASH. POST, Aug. 9, 2003, at E1.

255. *Id.*

256. *Id.*

257. *Id.*

258. *Id.*

259. Leslie Wayne, *Turmoil at WorldCom: Retirement Money; Irate Over all the Scandals and Big Losses, Pension Funds are Going to Court*, N.Y TIMES, June 28, 2002, at C1.

Wisconsin state pension fund lost $36.3 million through the WorldCom collapse, the Michigan state employee fund lost $116 million, and the Iowa state pension fund lost $33 million.[260] Michael L. Fitzgerald, state treasurer of Iowa, said:

> I'm outraged. We have invested in the American marketplace and we have lost confidence. There is now no confidence in people who are running these businesses. No trust in them at all. Institutional investors need to pick up the mantle of litigation. Who's watching those guys at the top? They are proving to be bald-faced liars.[261]

The lawsuits by all concerned private parties against Enron and Andersen will continue for sometime. Enron workers and investors are seeking $26 billion in a class-action suit that also names Enron and Andersen executives and board members.[262] Private suits brought by investors against outside directors of Enron for fraud and insider trading were dismissed in March 2003, for failure to show intent by the directors.[263] Suits for negligence, however, might still be possible.[264]

Given that most of these shareholder suits are settled for far lesser amounts though, the question remains what effect they really have on corporate misconduct. For firms like Enron and Andersen that no longer exist or exist in vastly diminished scale, the lack of connection is obvious. Even for any living entities, though, the effect is dubious. Former SEC Commissioner and Stanford Law Professor Joseph Grundfest concludes:

> I'm not suggesting that [the class-action system] has no deterrent effect. It's just weak compared with the criminal and the SEC enforcement mechanisms. The reason is that only 0.5 percent of the settlements in the fifteen largest settlements came out of the pockets of the wrongdoer. The vast amount of the money that is used to fund these settlements comes from the corporation, the defendant in the action. And who owns the corporation? The shareholders. The shareholders are also the plaintiffs who get the recovery. So there is no securities fairy paying the settlements. We're simply moving money from investors' right pocket to investors' left pocket – and paying lawyers a lot for moving the money around.[265]

*Arbitration versus Litigation:* The choice between arbitration and litigation is important for private plaintiffs bringing action against investment analysts and brokers, as well as against their firms. There is also a regulatory component provided by the $1.4 billion Wall Street settlement, as aggrieved investors who were victimized by fraudulent stock ratings might claim relief from the restitution

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260. *Id.*

261. *Id.*

262. *Five Ex-Andersen Execs Won't Face Enron Shareholder Suit: Judge Throws out Claims Against Group Including In-house Lawyer Claims Against Others Proceed*, L.A. TIMES, Jan. 29, 2003, at B7

263. Kurt Eichenwald, *Enron's Outside Directors Win Round in Court*, N.Y TIMES, Mar. 14, 2003, at C6.

264. *Id.*

265. Joseph Grundfest & Nicholas Varchaver, *Winona, Martha & the Securities Fairy*, FORTUNE, Aug. 11, 2003, at 50.

fund established by the settlement.[266] Those bringing individual court cases are having a difficult time recovering, however.

In the main, investors are left with the remedies provided by arbitration, since a 1987 Supreme Court case held that securities firms may force their clients into arbitration when provided by contract.[267] Plaintiffs complain that arbitration tends to favor the industry, and studies tend to bear that out.[268] In the case of California, however, the arbitration requirement may be eroded or bypassed due to a state ethics law that requires arbitrators to disclose their financial dealings and any conflicts of interest. The NASD, which hears 90 percent of all securities arbitrations, has asked any claimants to waive the application of the new law, and securities firms argue the law should be preempted by federal regulations.[269] A federal appellate court has just upheld the law in the face of those arguments.[270]

Some recovery may be easier in arbitration than in court, as arbitrators tend to be more concerned about a fair result than about technical procedures and burdens of proof. Nonetheless, even in arbitration, an investor or complainant must demonstrate "specific reliance" on the advice of a broker or analyst in causing his/her loss,[271] which is often difficult to show. Some state laws give investors broader relief if they can show that an adviser failed to disclose pertinent facts, such as an investment banking relationship with the covered company.[272] Arbitration does not lend itself to a mass-tort class-action approach, but some lawyers are trying it anyway in the research analyst cases. One team of lawyers has signed up 9,000 potential plaintiffs through the website stockmarketfraud.com, and a Florida law firm represents 6,000 more.[273]

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266. Anitha Reddy, *Investors Eligible for Restitution; Settlement will also Aid Class Actions*, WASH. POST, Apr. 30, 2003, at E1. *See also* Ben White and Kathleen Day, *SEC Approves Wall Street Settlement; Conflicts of Interest Targeted*, WASH. POST, Apr. 29, 2003, at A1, Ben White, *SEC Pushes for Approval of Wall St. Deal*, WASH. POST, June 17, 2003, at E1; Amy Baldwin, *Don't Count on Restitution Money; Fund Investors Unlikely to get Piece of Wall Street' $387.5 Million Pie*, WASH. POST, May 11, 2003, at F4.

267 Walter Hamilton, *Californians May Win Right to Sue Brokerages: Appellate Ruling Could Lead to Precedent Allowing Investors to Bypass Arbitration*, L.A. TIMES, Aug. 21, 2003, at B1.

268. Brooke A. Masters, *Few Gains for Investors Suing Over Research; Arbitration Panels Awarding Little if Anything in Cases Based on Stock Analysts Conflicts*, WASH. POST, Aug. 14, 2003, at E1. *See* also Walter Hamilton, *Aggrieved Investors Face the Big Fight; Contentious Brokerage Arbitration Renews Debate on how it Works and Whether it's Fair* L.A. TIMES, July 27, 2003, at B1.

269. *See* Hamilton, *supra* note 268.

270. *Id.*

271. Brooke A. Masters, *Laying Claim to Arbitration; Law Firm Aims to Dominate Investor Securities Cases*, WASH. POST, Aug. 20, 2003, at E1. *See also* Brooke A. Masters, *Investors v. Brokers; Meting out Quick Justice in Murky World of Arbitration*, WASH. POST, July 15, 2003, at E1.

272. *See* Masters, *supra* note 268.

273. *See* Brooke A. Masters and Ben White, *Wall St. Facing Legal Blitz: 'Global' Settlement Prompts Investor to File Claims*, WASH. POST, July 3, 2003, at E1 (for other figures on the expanding number of arbitration cases); *see also* Ben White and Brooke A. Masters, *Investor Suits Against Wall St. Firms Rejected; Federal Judges Dismiss Class Action Blaming Research Reports for Technology-Stock Losses*, WASH. POST, July 2, 2003, at E1 (for an account of an important victory for Merrill Lynch & Co. and the dismissal of class action suit by investors by Senior U.S. District Judge Milton Pollack).

The individual arbitrations conducted thus far have not been successful for injured investors. About a dozen cases, ranging all the way up to $30 million in claimed damages have been decided, and only two plaintiffs have received any awards.[274] Still the cases have really only begun. The NASD has received around 300 filed cases, with thousands more expected, and the NYSE has received almost 100.[275]

## IMPACT OF REGULATION

With the passage of Sarbanes-Oxley, the debate now ensues over its impact. Will it deter fraud? Will the costs of compliance be excessive? Will it improve boards of directors or make it more difficult to attract top candidates? Will it make management too cautious and risk averse? Will it delay too many decisions and drive them to the top? Most important, will it restore investor confidence? The answers vary from one expert to another. It may also take a long time to assess the effectiveness of the act and new controls, since financial fraud is more typical at the end of long bull runs on Wall Street.

*Cost of Controls:* Beyond the debate over the definition of proper "internal controls, there is a deep concern over the cost of those controls. Some see Sarbanes-Oxley as ironically a windfall for the accounting industry One business journalist suggests it may raise audit fees by 30-100 percent.[276] Colleen A. Sayther, chief executive of Financial Executives International said, "With all due respect to the accounting firms, there is a financial incentive for them to increase their amount of testing."[277] Greg W Matz, director of internal audit at Agilent Technologies, said, "[c]ontrols are not free. [Companies may] overspend without a lot of benefit or safety for the investor."[278] Meanwhile, William J. McDonough, chairman of the Public Accounting Oversight Board, maintains, in my view, good internal controls are cost effective and once put in place more than justify the expense involved."[279]

*Going Private:* Considering these costs, some firms have decided to either remain private or move from public back to private, partially in order to avoid the demands of Sarbanes Oxley.[280] Hence, the law does nothing to improve their corporate governance. In 2002, ninety-seven firms filed requests with the SEC to

274. *See* Masters, *supra* note 268.

275. *Id.*

276. Carrie Johnson, *Stiffer Accounting Standards Debated: Tougher Review Rules Planned*, WASH. POST, Aug. 9, 2003, at E1.

277. *Id.*

278. *Id., See also* Julie Hirschfield Davis, *For Sarbanes, the Grumbling was Expected*, BALT. SUN, July 29, 2003, at 1D (for additional estimates of compliance costs. The article notes that the Business Roundtable finds its member firms spending between $1 million and $10 million annually due to the new Sarbanes-Oxley law. Further, business law and consulting firm Foley & Lardner found that the cost of being a publicly traded firm has increased 100 percent due to new compliance requirements.).

279. *Id.*

280. Murray Coleman, *More Companies Exit Public Markets; New Accounting Rules Get the Blame Burden for Small Companies*, INVESTOR'S BUS. DAILY Aug. 26, 2003, at A1.

go private, and by July 31, 2003, sixty-seven firms had applied to go private.[281] Not only are the costs of compliance high for firms with little capital, but premiums for director and officer insurance policies have increased 30-40 percent since Sarbanes Oxley passed.[282] Small firms thus have great difficulty attracting willing outside directors. Given the Wall Street settlement with investment banking firms, and their commensurate needs to downsize among their analyst corps, some thinly traded small companies no longer enjoy analyst coverage at all. Hence, the benefits of remaining public pale in contrast to the costs. As the CFO of Tumbleweed, a small restaurant chain, put it, "We didn't see much value in being public. It was costing us a lot of extra money. Then Sarbanes-Oxley came along and that was the last straw."[283] Tom Taulli, a finance professor at the University of Southern California concludes that, with the added costs and restrictions of Sarbanes-Oxley, the tradeoffs are looking much better to go private."[284]

*Recruiting Board Members:* Given the enhanced responsibilities of directors and the stronger criminal penalties, some believe that many qualified candidates will now find board positions far less attractive and that it will be difficult to build strong boards. As defense attorney Ira Lee Sorkin states, "Why would someone want to be a director and face all this potential exposure?"[285]

*Executive Reactions:* Not surprisingly, most senior executives have a dim view of Sarbanes-Oxley as they might of most other regulation. A survey of 192 senior executives in the July 28, 2003 *Financial Times* found that 60 percent believe that reform has gone too far.[286] Further, a poll of CFOs and managing directors found that only 30 percent have a good opinion of Sarbanes Oxley [287] When trying to gauge the effectiveness of new reforms, professional money managers are skeptical of their likely effect. In a recent survey, just 23 percent said recent antifraud measures had been effective, and 60 percent doubted even the recent Wall Street settlement would improve the quality of brokerage research.[288] Still, half of the respondents supported the efforts of local and state regulators. As the chief coordinator of the study reported, "The support of these fund managers for the state securities regulators suggests somewhat of a lack of confidence in the ability of the S.E.C. to do its job."[289]

*Internal Investigations:* Whatever actual change in corporate behavior is

281. *Id.*

282. *Id.*

283. Murray Coleman, *More Companies Exit Public Markets: New Accounting Rules Get the Blame*, INVESTORS BUS. DAILY, *at* http://www.mergerforum.com/ibdarticle.cfm (last visited Mar. 3, 2004).

284. *Id.*

285. Alex Berenson, *A U.S. Push on Accounting Fraud*, N.Y TIMES, April 9, 2003, at C1.

286. Adrian Michaels, *Reforms Lose Support of Business Leaders Corporate Governance*, FIN. TIMES (London), July 28, 2003, at 24.

287 Wes Pedersen, *Move On, Corporate America!*, IMPACT, July-Aug., 2003, at 3-4.

288. Gretchen Morgenson, *Wall Street Reform Falls Short, Survey Says*, N.Y TIMES, Aug. 31, 2003, at 6.

289. *Id.*

produced by new regulations, the scandals certainly have invited close scrutiny and outside pressure brought by former top SEC officials and law enforcement officers. Investigators have been installed by courts and boards of directors to supervise internal investigations that have produced enlightening reports.[290] Former SEC general counsel William McLucas has supervised internal investigations at Enron, WorldCom (at the invitation of the board), and Qwest Communications.[291] Former Attorney General Richard Thornburgh supervised another investigation of WorldCom for the bankruptcy court, and former SEC official Gregory S. Bruch coordinated the internal investigation at Global Crossing.[292] Attorney David Boies, who litigated the monopoly case against Microsoft, supervised internal investigations of Tyco,[293] while former SEC counsel Richard Doty conducted an internal investigation of Freddie Mac.[294] The bankruptcy judge in the Enron case appointed R. Neal Batson, an Atlanta attorney, who concluded creditors might be entitled to recover $5 billion in assets improperly transferred to outside partnerships and to $74 million in loans received by Chairman Kenneth Lay.[295] He also found that CFO Fastow received twice as much as reported, and that Enron manipulated the tax laws to create "phantom" tax losses.[296]

*Corporate Monitors:* The government has also installed former SEC Chairman Richard Breeden to monitor and approve of business decisions at WorldCom, as Gregory Bruch is now doing for U.S. Technologies.[297] Such officials provide a valuable service in discovering all the elements of corporate misconduct, in the case of investigations, and of setting the ship aright again, in the case of corporate monitors.[298]

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290. One example is the internal investigative report on Enron, known as the *Powers Report*. The investigation was chaired by William C. Powers, Jr., an outside director on the Enron board and Dean of the University of Texas Law School. *See* William C. Powers, Jr., Raymond S. Troubh, and Herbert S. Winokur, Jr., *Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, Feb. 1. 2002, *available at* http://bodurtha.georgetown.edu/enron/Board_Special_Report.htm (last visited Feb. 16, 2004).

291. Brooke A. Masters, *Ex-SEC Lawyer to Mind U.S. Technologies*, WASH. POST, Mar. 18, 2003, at E4. *See also* Floyd Norris, *Ebbers and Passive Directors Blamed for WorldCom Woes*, N.Y TIMES, June 10, 2003, at C1.

292. Christopher Stern, *Two Reports Fault Founder on WorldCom Operation: Atmosphere Allowed Deception, Probe Says*, WASH. POST, June 10, 2003, at A1.

293. Ben White, *Tyco Replaces Chief Lawyer is Hit with Downgrade of Debt*, WASH. POST, June 11, 2002, at E1; *see also* Alex Berenson, *Now, Questions Turn to Why Tyco Lawyer Received Bonus*, N.Y TIMES, June 12, 2002, at C1.

294. Kathleen Day, *Report Faults Freddie Mac Officials; Board says Firm's Culture led to Transactions that Forced Restatements*, WASH. POST, July 24, 2003, at E1.

295. Peter Behr, *Recovering for Enron Creditors; $5 Billion in Assets were Improperly Treated, Report Says*, WASH. POST, Mar. 7, 2003, at E2.

296. *Id.*

297. *See* Masters, *supra* note 258.

298. *Id.*

Some see Sarbanes-Oxley as misdirected, that it really won't do much to cure most of the corporate abuses and real problems of corporate governance. Some say the real problem is not lack of director independence but directors simply not working hard enough.[299] Separating auditing from non-audit services won't do much, some say, because the auditor still has an interest in ingratiating the client in order to retain its audit business.[300] As one analyst puts it, " even if auditing firms have to get out of the consulting business, the temptation for auditors to please the people they are paid to police will still be there."[301] The better approach is one of a genuine check and balance between two audit firms, through a forensic audit or periodic rotation of audit firms.

*Alternative Reforms:* Before resigning as SEC Chairman and even before the debate over Sarbanes-Oxley Harvey Pitt suggested that companies be subject periodically to full-scale forensic audits by a different audit firm.[302] Regular auditors normally review just a sample of company records and take management's words at face value. Forensic audits probe more deeply and would more likely uncover any real problems.[303] Other experts have suggested regular rotation of the audit firm, not just of the auditors within a firm, going well beyond the requirements of Sarbanes-Oxley which only requires the two principal partners involved in the audit be rotated every five years.[304] Bypassing the normal biases and relationships built up over time between a firm and its client is the only path that some see to true independence. Requiring forensic audits might create a lot of new business for audit firms, so one might suspect they would lobby for such a rule. More frequent rotation, however, might create disruption and transaction costs and therefore stimulate political opposition by the auditors.

*Only Auditing:* If Sarbanes-Oxley has minimal impact, another option worth considering is what Paul Volcker suggested as his condition of leading Arthur Andersen – forego consulting altogether and stick to auditing.[305] Despite the financial and business sacrifices that would entail for the firm, perhaps a model built for modest success and integrity of the business system overall is a better alternative for the future. As Volcker said, "We've missed an opportunity of having an accounting firm of some weight doing auditing the way it seems to me it

299. *See* Sonnenfeld, *supra* note 13.

300. Gellerman, *supra* note 41, at 23 n.3.

301. *Id.*

302. David S. Hilzenrath, *Forensic Auditors Find What Some Companies Try to Hide*, WASH. POST, Nov. 23, 2002, at E1.

303. *Id.*

304. Max H. Bazerman, et al., *Why Good Accountants Do Bad Audits*, 80 HARV. BUS. REV. 96, 102 (2002).

305. Kurt Eichenwald, *Miscues, Missteps, and the Fall of Andersen*, N.Y TIMES, May 8, 2002, at C1.

should be done. Andersen is now a very lame horse, a lame horse that got shot in the head."[306] Further, as the U.S. editor and a correspondent for the *Economist* contend:

> Enron is certainly an opportunity to instigate some long overdue corporate reforms. It was always a recipe for disaster that accountants were allowed to do consulting. It was always a scandal that chief executives were allowed to design their own remuneration packages. Despite some screams from the business lobby, new laws to restrict such abuses make sense.[307]

*Ban Tax Services:* While Sarbanes-Oxley bans auditors from providing certain kinds of consulting services – human resources and technology systems, it has not banned tax services or consulting on tax shelters, leaving that up to corporate audit committees to approve or not.[308] In January 2003, the SEC voted to allow tax services and consulting to continue, subject to approval by corporate boards and under the supervision of audit committees.[309]

*Abolish Banking/Brokerage Combination:* As for the provision in the Wall Street settlement requiring that analysts not be compensated for any investment banking business brought to the firm nor go on "road shows" for clients with the bankers, some maintain that is misdirected and insufficient as well.[310] Even without direct contact with the bankers and incentive pay based on touting client stocks, everyone in the firm knows that its overall success is inextricably tied to that of its clients. Scott Cleland of the Precursor Group, an independent research firm, observes that the entire model, based on research, trading, and banking is inherently conflicted.[311] That diagnosis leads to the conclusion that investment banking and securities analysis/brokerage should not exist under the same roof. They should be entirely separated, based on the model of the Precursor Group. For investment banking firms to be required to supplement their own analysis with that of truly independent firms, as stipulated by the Wall Street Settlement, might insure some check and balance, but is a tacit admission that the investment banking/analysis model has flaws.

*Mutual Fund Industry Regulation:* With the passage of Sarbanes-Oxley, the attention is shifting from corporate fraud to abuses by the mutual fund industry More aggressive than the SEC on this score is Rep. Richard Baker (R-LA), who has proposed legislation requiring greater disclosure of fees paid by individual investors, disclosure of the compensation structure for fund managers, and regulation of "soft dollar" commissions, in which funds pay higher than normal

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306. *Id.*

307. John Micklethwait & Adrian Wooldridge, *A Corporate Crisis? No, Just Business As Usual*, WASH. POST, June 23, 2002, at B1.

308. Kathleen Day, *SEC Allows Auditors as Tax Consultants*, WASH. POST, Jan. 23, 2003, at A1; David S. Hilzenrath, *Audit Firms Battle Curbs on Services*, WASH. POST, Jan. 16, 2003, at E1.

309. *Id.*

310. Patrick McGeehan, *For Financial Firms, Proposed New Rules on Analysts are the Least of Their Problems*, N.Y TIMES, May 8, 2002, at C2.

311. *Id.*

commissions in return for research, with the costs passed on to fund investors.[312] The Baker bill also would increase the mandated percentage of independent directors on fund boards from 40 percent to 67 percent.[313]

That legislation, the Mutual Fund Integrity and Fee Transparency Act of 2003, managed to get through the House Financial Services Committee, but is likely to die on the House floor[314] Industry lobbyists succeeded in watering down the final reform bill, and reform advocate Jack Bogle concluded, "If a journey of a thousand miles begins with a single step, I'd say this legislation still leaves us many hundreds of miles to go."[315] Jack Bogle has roundly criticized the industry he helped create and has been a crusader for reform.[316] He charges most funds with charging excessive fees, with insufficient disclosure of portfolio holdings, with failing to provide an informed choice to investors, with failing to compensate fund managers according to their performance, with excessively turning over stock holdings, with failing to disclose its votes on shareholder resolutions, with insufficiently holding management in invested firms accountable, and when all is said and done, with underperforming the market.[317] Bogle and others believe the governance and practices of this industry are the next best targets and candidates for reform.[318]

*Governance of the Stock Exchanges:* One matter not addressed by Sarbanes-Oxley related to the integrity of the listing process itself concerns the governance of the major stock exchanges, especially the NYSE. The controversy surrounding Chairman Richard Grasso's $10 million salary in 2002, and his deferred compensation package of $139 million, has brought more scrutiny to the NYSE's integrity[319] That Grasso and the founder of Home Depot sat on each other's compensation committees also raised questions of NYSE's governance process.[320] While the self-regulatory organizations will require listed companies to have a majority of independent directors by October 2004, they could set a better example by themselves having more independence on their own boards.[321] Ten of the twenty-seven board members of the NYSE were from either listed companies or the securities industry prior to new NYSE Director John Reed downsizing the

312. Floyd Norris, *For Mutual Funds, Calls for Reform*, N.Y TIMES, June 15, 2003, at 3.7

313. *Id.*

314. Paul B. Farrell, *Fund Reform is Dead: Congress Passing Buck to Do-Nothing SEC*, CBS.MARKETWATCH.COM, Aug. 14, 2003, *available at* http://cbs.marketwatch.com (last visited Jan. 29, 2004).

315. *Id.*

316. Justin Fox, *Saint Jack on the Attack*, FORTUNE, Jan. 20, 2003, at 112

317. *Id.*

318. *Id.*

319. Floyd Norris & Landon Thomas, Jr., *Grasso Giving Up $48 Million in Benefits*, N.Y TIMES, Sept. 10, 2003, at C1; Walter Hamilton & Kathy M. Kristof, *SEC Chief Rips Huge Grasso Pay Package*, L.A. TIMES, Sept. 3, 2003, at C1; Landon Thomas, Jr., *A Pay Package that Fat Cats Call Excessive*, N.Y TIMES, Aug. 29, 2003, at C1.

320. Ben White, *NYSE Sets Tighter Rules for Its Officers*, WASH. POST, June 6, 2003, at E1; Gretchen Morgenson & Landon Thomas, Jr., *Chairman Quits Stock Exchange in Furor Over Pay*, N.Y TIMES, Sept. 18, 2003, at A1.

321. White, *supra* note 196.

board, and that is also true of six of the twenty-one NASDAQ board members.[322] New York Attorney General Eliot Spitzer contends that, "Fixing self-regulation is perhaps the most important policy issue facing the SEC."[323]

## MARKET REFORMS

As noted, there are compliance costs and administrative costs from Sarbanes-Oxley that have met with criticism. Most of the costs are surely yet to be realized. Further, there are questions whether the provisions of Sarbanes-Oxley are misdirected and will markedly improve corporate governance. As *The Economist* concludes, "[n]ew federal laws, such as the Sarbanes-Oxley Act, have created a dense thicket of rules prescribing good behaviour in the boardroom. But the system's essential features – weak boards, muted shareholder participation and sweeping power for the boss – so far remain intact."[324] At the same time, the corporate scandals have generated a spirit of reform in the marketplace that has produced other results. Whether the reforms voluntarily adopted by corporations will turn out to be better than the widespread reforms forced by regulation remain to be seen, but scandal-ridden companies like WorldCom are actually leading the way toward the most ambitious reforms. MCI/WorldCom will be adopting many of the seventy-eight reforms urged in the Breeden Report, "Restoring Trust."[325] Most of the reforms go well beyond the requirements of Sarbanes-Oxley The major reforms in corporate governance recommended include:

> Outside director as chairman of board;
> Full independence for all directors;
> Ban CEO from serving on any other corporate boards;
> CEO salary capped at $15 million without shareholder approval;
> When board is divided on new candidates, contested elections must be held;
> Heavier director workload, salary increased to $150,000;
> Explicit dividend policy, paying 25 percent of net profits;
> Electronic "town hall" meetings on company website ideas with 20 percent support go to annual meeting; and,
> Governance rules become part of articles of incorporation, not corporate bylaws, and can be changed only with shareholder approval.[326]

In the case of WorldCom, of course, there are unique factors that may have propelled the company to take more drastic steps in reforming itself. Those factors include:

> The extent of damage created to shareholders by the collapse of WorldCom, to the tune of $180 billion in lost market capitalization;

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322. Paula Dwyer, *Why the Market Can't Police Itself*, BUS. WK., June 2, 2003, at 84.

323. *Id.*

324. *WorldCom's Revenge*, ECONOMIST, Aug. 30, 2003, at 44-45.

325. Christopher Stern, *WorldCom to Put Curbs on CEO's Pay, Influence*, WASH. POST, Aug. 26, 2003, at E1.

326. *Id.*

The fact that WorldCom's reorganization under the bankruptcy laws has been roundly criticized by those who believe the company should instead be liquidated;
The blatant nature of the company's accounting fraud and the fact that four top executives have already pleaded guilty·
- The criticism of the company's $750 million settlement with the SEC as being totally insufficient;
The assault brought against MCI/WorldCom by its competitors (Verizon, AT&T and SBC) and their political allies in Congress. AT&T has even brought a suit under RICO (Racketeer Influenced and Corrupt Organizations Act) against MCI/WorldCom for its illegal routing of phone calls;
The sweeping and harsh criticisms of the company's board and senior management by the McLucas Report, requested by the company's board, and by the Thornburgh Report, requested by the bankruptcy judge;
The company's favored position as a major government contractor, along with the decision by the Government Services Administration (GSA) that the company be suspended from bidding on any new government contracts; and,
The criminal charges for securities fraud brought by the state attorney general of Oklahoma against the company and its senior executives, likely to be followed by similar charges by other states.[327]

Given all of these political and legal pressures, the company perhaps felt it had to take bold steps, in hopes of defusing some of those pressures. Other companies not facing such a barrage of forces are unlikely to adopt such ambitious internal reforms.

## GLOBAL CORPORATE GOVERNANCE

Changes in corporate governance are taking place in other political-economic systems as well, though not always parallel to those changes in the U.S. There are other pressing legal issues surrounding global corporate governance as well, including the application of the Sarbanes-Oxley Act to overseas auditors, the scope and integrity of foreign regulatory bodies, and the evolution of global accounting standards.

*Corporate Governance Standards in other Countries:* The roles of corporate boards and shareholders are being debated in other countries, just as they are in the U.S., but with some marked differences, depending on the country or region.[328]

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327 Christopher Stern, et al., *Oklahoma Plans to Charge Ebbers, WorldCom*, WASH. POST, Aug. 27, 2003, at E1; Christopher Stern & Brooke A. Masters, *WorldCom, Ex-Officers Charged in Oklahoma*, WASH. POST, Aug. 28, 2003, at E1; Joseph Menn, *WorldCom Puts Him in the Spotlight*, L.A. TIMES, Aug. 30, 2003, at C1; Barnaby J. Feder & Kurt Eichenwald, *A State Pursues WorldCom*, N.Y TIMES, Aug. 28, 2003 at C1.

328. Katharina Pistor, et al., *The Evolution of Corporate Law: A Cross-Country Comparison*, 23 U. PA. J. INT'L ECON. L. 791 (2002); Kerry S. Burke, *Regulating Corporate Governance Through the Market: Comparing the Approaches of the United States, Canada and the United Kingdom*, 27 J.CORP

Wisely or not, attention has focused on the independence of boards and directors in the U.S. That is somewhat true of other countries as well, but their requirements and laws often have a different emphasis. For instance, following the publication of the Cadbury Commission recommendations in 1992, corporations in the UK have gone much further than American companies in separating the roles of chairman and CEO.[329] While in 1990, 90 percent of both U.S. and U.K. companies combined the CEO and chairman positions, about 85 percent of FTSE 100 companies today separate those positions, while the situation is still the same in the U.S.[330] The emphasis on empowering independent (or non-executive) directors has occurred more recently in the U.K. and earlier in the U.S. The Higgs Report includes two recommendations that most corporate chairmen find objectionable – that a senior non-executive be designated on the board, opposed by 82 percent of all chairmen; and a nomination committee be chaired by an independent non-executive director, opposed by 87 percent of all chairmen.[331]

In France, independent directors are becoming somewhat more common. There are no regulatory standards on independence, as in the U.S., but high-level reports have recommended that the percentage of independent directors be increased, the first report recommending a level of one third, and the second report recommending one half. Genuine independence is more problematic, as most corporate board members represent the French elite and are graduates of two exclusive institutions of higher education.[332] Some companies, especially those with well publicized problems, have nonetheless moved in the direction of more independent boards. Vivendi Universal, with the controversy surrounding its accounting and CEO compensation, now has an audit committee completely filled with independent directors.[333] Moreover, the number of European boards having at least one independent member, no great progress by U.S. standards, has nonetheless risen from 53 percent in 2001 to 59 percent in 2002.[334]

In South Korea, with its history of poor corporate governance, family dynasties called chaebol rule over large conglomerates, with opaque subcompanies controlled through extensive networks of cross-shareholding.[335] While the boards of such companies formerly had no outside directors, the situation is slowly changing. At Samsung Electronics, half of its fourteen board members are now outsiders, and its audit committee is totally composed of outsiders.[336] KT Corporation, the largest phone and broadband company in Korea, just recently

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L. 341 (2002); Douglas M. Branson, *The Very Uncertain Prospect of "Global" Convergence in Corporate Governance*, 34 CORNELL INT'L L.J. 321 (2001).

329. Paul F Kocourek, et al., *Corporate Governance: Hard Facts about Soft Behaviors*, 30 STRATEGY + BUSINESS 58 (2003), *available at* http://www.strategy-business.com/press/article/8322?pg=0 (last visited Jan. 30, 2004).

330. *Id.*

331. *British Corporate Governance: Hating Higgs*, ECONOMIST, Mar. 15, 2003, at 63.

332. *French Corporate Governance: Independent? Moi?* ECONOMIST, Mar. 15, 2003, at 63.

333. Kerry Capell, *Opening Up the Boardroom*, BUS. WK., May 19, 2003, at 50.

334. *Id.*

335. Moon Ihlwan, *Crackdown on Korea, Inc.*, BUS. WK., May 19, 2003, at 44.

336. *Id.*

privatized, is one of few companies in Asia with an independent director as chairman of the board.[337]

Beyond the issue of independent boards, not as big an issue in other countries as in the U.S., there has been a movement in many global regions toward the adoption of board committee structures. Companies in the U.K. and European countries most often have compensation or remuneration committees, along with audit committees.[338] Leading companies in Japan, like Sony and Hitachi, have also put such committees in place.[339] Corporate governance codes, while setting only voluntary standards, are becoming more common throughout Europe. During 2002, Spain and Germany introduced governance codes for public companies, while Italy and France updated their own codes.[340] The German Stock Corporation Act also requires companies to disclose how well they comply with the corporate governance code.[341] Over time, the European Commission also intends to harmonize the over 40 European corporate governance codes.[342]

Boards all across the globe are now holding CEOs more accountable for their failures to perform while in office. CEO turnover is up "192 percent in Europe and 140 percent in the Asia/Pacific region since 1995, and 45 percent of all CEO replacements in the Asia/Pacific region in 2002 were related to corporate performance.[343] The percentage of performance-related dismissals increased ten-fold between 2001 and 2002.[344] Japan also revised its commercial code in 2002 to encourage companies to have outside directors.[345]

Despite increased accountability inattentive boards that fail to exercise diligence are a common problem in other countries, just as they are in the U.S. Boards dominated by strong-willed CEOs are also just as common in other countries as in the U.S. For instance, Cees van der Hoeven, CEO of Ahold, was a growth- and acquisition-focused executive and in many ways Europe's counterpart to General Electric's Jack Welch.[346] After the scandal surfaced, the company's board rejected his offer to resign due to his personality and power of persuasion.[347] In other words, the board may have been too intimidated to even allow the CEO to fall on his own sword.

*Shareholder Activism:* Shareholder activism is much more prevalent in the U.S. than in other countries, but the gap is narrowing in two ways. First, U.S.

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337. *Id.*

338. Capell, *supra* note 333.

339. Ken Belson, *At Meetings Abroad, Raucousness and Hoopla*, N.Y TIMES, May 11, 2003, at 3.10.

340. Capell, *supra* note 333.

341. *Id.*

342. *Id.*

343. Chuck Lucier, Rob Schuyt, & Eric Spiegel, *CEO Succession 2002: Deliver or Depart*, 31 STRATEGY + BUSINESS, 32 (2003), *available at* http://www.strategy-business.com/press/article/21700?pg=all&tid=230 (last visited Jan. 30, 2004).

344. *Id.*

345. *Id.*

346. Robert J. McCartney, *Food Baron Fall Shakes Dutch*, WASH. POST, Mar. 1, 2003, at A1.

347. *Id.*

shareholder groups, whether church organizations like the Interfaith Center for Corporate Responsibility or mainstream institutional shareholders, will occasionally challenge the practices of firms in which they own shares that are based in other countries. That trend moved forward in the 1990s. For instance, in Europe, U.S. pension funds like TIAA-CREF which has an aggressive corporate governance department, are joining forces with European funds to bring pressure on companies based in Europe.[348] More recently, shareholders in other countries have organized to pressure companies in their own homelands. As one scholar put it, After years of relative isolation as primarily U.S. and British phenomenon, shareholder activism has finally shown signs of going global."[349] For instance, related to the Ahold scandal, a Dutch shareholder watchdog group called the Foundation for Investigation of Business Information has applied pressure for the CEO to return a large portion of his compensation.[350] There is also a Dutch Association of Shareholders, a more traditional group.[351] In France, since Alcatel has sought investors in the U.S. capital market, it has faced pressure from U.S. shareholder interests, while it has also had to face increasing pressure from French shareholders.[352] France now faces the question whether it is moving more in the direction of the American "shareholder democracy" model and abandoning its previous "stakeholder" model.[353]

Having acknowledged the growing activism of shareholders in the U.S., there are still corporate governance experts who claim that shareholder powers pale in contrast to those of directors, since the American model is much more director-centric.[354] In the U.S. and under the Delaware code, Bainbridge argues, "Shareholder control rights are so weak that they scarcely qualify as part of corporate governance."[355] Even as to institutional investors, he states:

> There is relatively little evidence that institutional investor activism has mattered. Although about fifty percent of equity securities are owned by institutions, large blocks held by a single investor are rare, and few U.S. corporations have any institutional shareholders who own more than five-to-ten percent of their stock. Even the most active institutional investors spend only trifling amounts on corporate governance activism. Institutions devote little effort to monitoring management; to the contrary, they typically disclaim the ability or desire to decide company-specific policy questions. They rarely conduct proxy

348. Capell, *supra* note 333.

349. Perry E. Wallace, *The Globalization of Corporate Governance: Shareholder Protection, Hostile Takeovers and the Evolving Corporate Environment in France*, 18 CONN. J. INT'L L. 1 (2002).

350. McCartney, *supra* note 346.

351. *Id.* (While this organization caters more to mainstream shareholders, the Foundation for Investigation of Business Information is more akin to groups in the U.S. like the Interfaith Center for Corporate Responsibility and is more prone to be aggressive and activist in its demands.).

352. Wallace, *supra* note 349, at 14.

353. *Id.* at 3.

354. Stephen M. Bainbridge, *Director v. Shareholder Primacy in the Convergence Debate*, 16 TRANSNAT'L LAW 45, 46 (2002).

355. *Id.* at 48.

solicitations or put forward shareholder proposals.[356]

That view of course conflicts with others discussed above. Meanwhile, even though the U.K. shares a common law foundation with the U.S., as well as many features of its corporate model, there the emphasis is much more on shareholder rights and powers. Hence, while directors are held much more accountable for executive salaries in the U.S., the U.K. has recently given shareholders the power to approve of CEO pay packages.

Even though shareholder meetings of Japanese companies have been historically friendly and quiet, they have also contended with professional disrupters, known as sokaiya, who demand hush money from corporations involved in scandal.[357] Companies have largely succeeded in thwarting those elements, but now legitimate shareholders have begun challenging management in proxy votes.[358]

In South Korea, foreigners own more than a third of the shares of companies listed on the Seoul stock exchange, and they are the primary forces promoting corporate governance reform.[359] Indigenous political forces also have the issue on their agenda, especially since the stock manipulation scandal involving SK Corporation, the country's third largest conglomerate.[360] A group called People's Solidarity for Participatory Democracy is seeking tighter restrictions on cross-shareholding, more outside directors, the ability to bring class action suits, and greater separation between banks and manufacturing companies.[361]

Organized shareholder groups are also forming in other countries, counterparts to the shareholder activist groups in the U.S. Beyond the Dutch groups mentioned above, South Korea has another group called the Center for Good Corporate Governance, and in the region, there is an Asian Corporate Governance Association.[362] In France, the major shareholder group is the Association pour la Defense des Actionnaires Minoritaires (ADAM).[363]

Pension funds have long been activist in the U.S., but mutual funds much less so, and hence the encouragement of Jack Bogle, founder of the Vanguard Funds, for mutual funds to exert much more pressure on corporate managements.[364] In European countries, such as the United Kingdom, activism by both pension funds and mutual funds has been at a much lower decibel, as only about 50 percent of all shares are voted, whereas the figure is closer to 80 percent in the U.S.[365] However, the volume is growing. Germany's second largest mutual fund is moving in an

356. *Id.* at 50.
357. Belson, *supra* note 339.
358. *Id.*
359. Moon Ihlwan, *Crackdown on Korea, Inc.*, BUS. WK., May 19, 2003, at 44.
360. *Id.*
361. *Id.*
362. *Id.*
363. *French Corporate Governance: Independent? Moi? supra* note 332, at 63.
364. Justin Fox, *Saint Jack on the Attack*, FORTUNE, Jan. 20, 2003, at 112.
365. *Will the Owners Please Stand Up?* ECONOMIST, Nov. 2, 2002, at 72.

activist direction, and the U.K.'s Institutional Shareholders Committee, representing pension funds, insurers, and mutual funds has adopted an activist code. Reflecting trends in the U.S., the U.K might also force funds to disclose how they vote on proxy resolutions.[366]

*Shareholder v. Stakeholder Models:* Many countries are following the Western model of corporate law and governance, including the wide dispersion of ownership to shareholders, in order to be listed on one of the U.S. stock exchanges and get access to greater capital in the U.S. Nevertheless, some experts believe it is arrogant and imperialistic for the U.S. to believe this trend is inevitable and to believe that its model of corporate governance is necessarily better.[367] Other models favor block ownership of shares, sometimes held by banks or families or other constituents, and emphasize accountability to other stakeholders besides shareholders.[368] One example is the European system of co-determination that favors accountability to labor through two-tiered boards of directors. In the face of other models, global convergence along the lines of the U.S. corporate governance model will likely never occur. As one critic puts it:

> The self-anointed corporate governance experts, elite as they may be in the United States corporate law academy, are not cognizant of the real issues of the twenty first century. Their advocacy of 'global' convergence, and that long the lines of United States style corporate governance, is not based upon 'global' developments, is culturally chauvinistic, and is anachronistic.[369]

A rich body of literature exists on the variables that account for the differences between shareholder and stakeholder accountability models. Why does one country embrace the shareholder model while another country follows the stakeholder model? One leading theory contends it is the quality of corporate law (QCL) that accounts for the difference and that common law systems facilitate the dispersion of shares and minority rights of shareholders, while civil law systems more often promote concentrated ownership with accountability to stakeholders.[370] This theory has generated a fair amount of criticism and counter-theories. John Coffee argues that the existence of a common law or civil law system has very little to do with the dispersion of ownership and shareholder power.[371] Were that the case, European civil law countries would not be able to move to a more shareholder-centric system, as many are now doing, and transitional economies with civil law systems would forever be trapped into a system of concentrated ownership. The QCL theory also cannot explain the thriving securities market in the Netherlands, a civil law country Coffee instead argues that the absence of

366. *Id.*

367 Douglas M. Branson, *The Very Uncertain Prospect of 'Global Convergence in Corporate Governance*, 34 CORNELL INT'L L.J. 321, 325 (2001).

368. *Id.* at 331.

369. *Id.* at 361.

370. Rafael LaPorta, et al., *Investor Protection And Corporate Governance*, 58 J. OF FIN. & ECON. 3, at 9.

371. John C. Coffee Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State In the Separation of Ownership and Control*, 111 YALE L. J. 1, 4-7 (2001).

state supervision is the critical factor leading to dispersion of ownership.[372] In such environments, as in the U.S., the U.K., and Canada, vibrant stock exchanges and self-regulatory systems emerge. They in turn give rise to accommodating common law systems, rather than the other way around. Coffee believes the QCL theorists have the causal chain backwards.[373] It is liquidity and stock exchanges that produce legal systems protective of shareholder rights.

To this debate, Mark Roe injects a political thesis. He argues that the type of corporate governance followed by a given system is determined by the politics underlying that system.[374] The legal system and type of state supervision are not the critical variables but the nature of the overall political system.[375] He maintains, through an analysis of wide-ranging comparative examples, that social democracies promote concentrated ownership and accountability to stakeholders, while capitalist democracies promote dispersed ownership and shareholder powers.[376] It is social democracies that strengthen the claims of non-shareholders such as labor. Peter Gourevitch offers a sympathetic critique of Roe's work, believing it is essentially accurate, but still questions some of its elements.[377] Roe and Gourevitch are both political scientists, so it is not strange that they would both stress the importance of the political system. Gourevitch argues that Roe focuses too much on the overall political system and ignores such variables within any given system as issues, interest groups, and institutions.[378] Any combination of those forces, even in a social democracy, could serve to empower shareholders and create dispersed ownership. Conversely, they might also lead to concentrated ownership and stakeholder empowerment in a capitalist democracy. Even in the U.S., there is an active debate within the academy and larger political society over the relative power of shareholders and other stakeholders, over the ownership structure of major corporations, and over the range of corporate accountability and obligations.

*Global Accounting Standards:* The corporate scandals in the U.S., along with the debate over conflicting standards of expensing stock options, have highlighted the differences between U.S. and other country standards. The U.S. is no longer viewed as the gold standard of either corporate governance or accounting standards. The International Accounting Standards Board (IASB) has led the way in the expensing of stock options, for example, with the Financial Accounting Standards Board (FASB) about to follow Some Europeans view its standards based on principles as more fair and less susceptible to abuse and corruption than the U.S. rules-based standards based on rules.[379] Ironically, the Roman law or code

372. *Id.* at 8.

373. *Id.* at 7.

374. *See* MARK ROE, POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE 11-13 (2003).

375. *Id.*

376. *Id.*

377 Peter A. Gourevitch, *The Politics of Corporate Governance Regulation*, 112 YALE L. J. 1829, 1878-1880.

378. *Id.* at 1878.

379. F Robert Buchanan, *International Accounting Harmonization: Developing Single World Standard*, 46 BUS. HORIZONS 3, at 61-70.

law countries of France and Germany have more general and flexible accounting standards than do the common law countries of the U.S. and U.K.[380]

There are other differences as well. The common-law countries of the U.S., U.K., Canada, and Australia are more "shareholder-focused" in their governance and accounting standards, while the code-law countries of Japan, Germany, and France represent bank-dominated economies and are more "stakeholder focused."[381] They also tend to demand less transparency than their common-law counterparts.[382] Belying the accusation that U.S. standards tend to encourage more reckless earnings management, one study found that:

> [A]ccounting earnings in common law countries are more conservative than reported earnings in code law countries, arising out of the arm's-length relationship between contracting parties (managers and shareholders). Reviewing the results of earnings suggests that bad news is incorporated more slowly and good news more quickly in code law than in common law countries.[383]

Indeed, when Daimler-Benz conformed its earnings statements to U.S. standards in 1993, prior to its merger with Chrysler, it converted a sizable gain to a sizeable loss.[384]

With the differences in U.S. and global accounting standards, and the criticisms of U.S. corporate scandals, there is a movement toward convergence of standards. European companies that have used GAAP standards to date will be moving toward international accounting standards. The goal of the FASB and IASB is to have uniform standards created by 2005.[385] Currently, the rules of the two bodies cover the U.S. and almost fifty other countries.[386] James Harrington of PricewaterhouseCoopers states, "[y]ou're looking at a whole paradigm of how the rules are made. It's a momentous change."[387]

Included among the advantages of convergence are lower compliance costs for transnational enterprises and the stimulation of more global capital flows.[388] On the debit side, even with uniform and flexible standards, the implementation of those standards will vary according to national and institutional cultures.[389] As to whether international convergence would prevent scandals like Enron in the future, one author writes:

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380. *Id.*

381. *Id.*

382. *Id.*

383. *Id.*, Grace Pownall & Katherine Schipper, *Implications of Accounting Research for the SEC' Consideration of International Accounting Standards for U.S. Securities Offerings*, 13 ACCT. HORIZONS 3, at 259-280 (1999).

384. Buchanan, *supra* note 379.

385. Jackie Spinner, *Rulemakers Move Closer to Global Accounting Standards*, WASH. POST, Sept. 19, 2002, at E4.

386. *Id.*

387. *Id.*

388. Buchanan, *supra* note 379.

389. *Id.*

> The Enron debacle, though having drawn great attention in the IFRS dialogue, is not an indicator of any fundamental accounting or regulatory system failure. Rather, it is a case of corrupt management that was seeking technicalities behind which to perpetrate investor fraud. It appears that its primary infraction, nondisclosure of off-balance sheet financing, might be more clearly prohibited under IFRS. That, however, would not necessarily have precluded them from fraudulent tactics under the international system, because the IFRS is generally less structured than U.S. GAAP and more interpretive latitude is available to corporate accountants.[390]

Supporting the view that international accounting standards might create even more chances for manipulation, an accounting expert stated, "[t]here's all this talk about how international accounting standards are better. When I hear that it just makes me sick to my stomach because I think it's so wrong. There's more flexibility in the international standards. It makes it where it's easier to do the kinds of things you want to do. .If they want to hide it, they're going to hide it."[391]

*Global Securities and Governance Standards:* Beyond the effort to harmonize accounting standards, international organizations are also attempting to harmonize securities and corporate governance standards. The International Organization of Securities Commissions (IOSCO), formed in 1974, is composed of 161 securities regulatory agencies from various parts of the world that agree: (1) to cooperate to promote high standards of regulation; (2) to exchange information to promote the development of securities markets; (3) to establish standards of effective surveillance of international securities transactions; and (4) to provide mutual assistance to promote effective enforcement and the integrity of markets.[392]

Meanwhile, the Organization for Economic Cooperation and Development (OECD) is attempting to promote and harmonize global corporate governance standards.[393] Examining its website one will see the areas of emphasis of its Ad Hoc Task Force on Corporate Governance.[394] The five sections of its governance principals cover the rights of shareholders, the equitable treatment of shareholders, the role of stakeholders, disclosure and transparency and the role of the board.[395]

*Application of Sarbanes-Oxley Act to Foreign Firms:* The Public Accounting Oversight Board has recommended that auditors of foreign companies whose shares are traded on U.S. exchanges must register with the SEC.[396] Such

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390. *Id.*

391. Carrie Johnson, *Deloitte Probe to Test Reach of U.S. Law*, WASH. POST, Feb. 28, 2003, at E1.

392. Felicia Kung, *The International Harmonization of Securities Laws: The Rationalization of Regulatory Internationalization*, 33 LAW & POL'Y INT'L BUS. 443, 465-66.

393. Colin Mayer, *Developing the Rules for Corporate Governance*, FIN. TIMES, Nov. 6, 2000, at 2; *see also* Christopher Adams, *Think Tank Rethinks Its Role*, FIN. TIMES, Sept. 24, 1999, at 4. *See also* Jane Martinson, *OECD Code to Safeguard Shareholders*, FIN. TIMES, April 10, 1999, at 5.

394. Organisation (sic) for Economic Cooperation and Development, *Principles of Corporate Governance*, April, 1998, *at* http://www,oecd.org/dataoecd/47/50/4347646.pdf (last visited Mar. 3, 2004).

395. *Id.* at 6.

396. Carrie Johnson, *Accounting Board Wants Foreign Firms to Register* WASH. POST, Mar. 5,

registration may also include annual inspections and the possibility of disciplinary action being taken. Left undecided are whether the inspections might extend overseas and whether overseas branches of Big Four American firms will be treated differently from audit companies based abroad. Some legislators such as Senators Christopher Dodd (D-Conn.) and Jon Corzine (D-N.J.) are concerned that if foreign auditors are exempted from the law that there will be an incentive for U.S. audit firms to move much of their operations abroad.[397]

In January 2003, the EU was initially pleased when the SEC announced limited exemptions from new rules for accounting and corporate governance. Included among the exemptions were (1) that foreign companies do not have to disclose that a financial expert on the audit committee is independent of management; (2) that non-management employees are allowed to serve on the audit committee, a common practice in Germany· and (3) that foreign lawyers are not required to report securities law violations within the firm, if they do not advise management on issues of U.S. law.[398] However, by April 2003, the EU was less pleased and was lobbying aggressively against any registration requirement.[399] Fritz Bolkenstein, the European commissioner in charge of market reform, wrote a threatening letter to SEC Chairman William Donaldson, on behalf of the 15 member finance ministers, warning that such a requirement would undermine confidence in financial markets and prompt reciprocal requirements for registration of U.S. audit firms in each EU member country.[400] The EU and European governments are concerned that their audit firms not be subject to conflicting laws and regulations and maintain that meeting U.S. disclosure requirements would violate European data protection laws.[401] They object to the law's coverage as unfair, since European firms are already subject to a large number of U.S. regulations.[402] The timing of the accounting fraud and restatement of over $800 million of earnings by Dutch food company Royal Ahold, however, stiffened the resolve of the PAOB to cover the conduct of foreign auditors as well.[403]

*Jurisdiction over Overseas Firms and Auditors:* When auditors working abroad have evidence of accounting fraud, the question arises over U.S. access to that information. When the Senate was investigating the BCCI (Bank of Credit and Commerce International) scandal in 1991, Pricewaterhouse contended that documents in its London office could not be subpoenaed, since the U.S. headquarters had no control over its foreign branch offices.[404] The firm now says it nevertheless regularly cooperates in supplying foreign work papers to the U.S.

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2003 at E3.

397. *Id.*

398. Robert J. McCartney, *Audit Exemptions Relieve Europeans*, WASH. POST, Jan. 25, 2003, at E2.

399. Paul Meller, *Europe Asks Compromise on Auditors*, N.Y TIMES, April 15, 2003, at 1.

400. *Id.*

401. *Id.*

402. *Id.*

403. Stephen Labaton, *S.E.C. Chief Has Plan to Pick Audit Board Head*, N.Y TIMES, Mar. 5, 2003, at 3.

404. Johnson, *supra* note 396.

government.[405] Foreign accounting firms must provide opinions and work papers, upon which a registered public accounting firm relies when issuing an audit report or anything that relates to its participation in an audit of a U.S. firm, though it does not have to provide other unrelated documents.[406] The U.S. Customs Office will also assist the SEC in tracking down documents by screening auditors when they cross the border and denying them passage unless they turn over the documents.[407] A KPMG auditor crossing the Mexican border turned over papers implicating Xerox Corporation in one such case, resulting in a $10 million settlement.[408]

The SEC and federal prosecutors also have jurisdiction over overseas companies based abroad that are listed on the New York Stock Exchange and may have engaged in fraud that harmed U.S. investors.[409] On that basis, the SEC has brought administrative proceedings against the Cronos Group, a Luxembourg company headquartered in England, and against its British accountants, for an alleged fraud in connection with an initial public offering in 1995.[410] The SEC has also asserted jurisdiction over the Ahold accounting investigation, since the company is listed in the U.S.[411]

*Regulatory Bodies in Foreign Countries:* In the U.S., the Justice Department and the SEC usually work together to examine accounting and securities fraud.[412] Most other countries lack the kind of serious regulatory framework and enforcement agencies that exist in the U.S. In the case of Royal Ahold's accounting fraud, it is being investigated by three entities in the Netherlands – the public prosecutor's office, the Netherlands Authority for Financial Markets, and Euronext Amsterdam NV the operator of the Dutch stock exchange.[413] However, no Dutch regulatory authority enjoys the sweeping powers of the SEC, and penalties for even such violations as insider trading are much milder than in the U.S.[414]

Having discussed both the voluntary changes in global corporate governance, as well as some of the comparative regulations of corporate governance, the following chart compares the ratings of corporate governance in leading European countries.

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405. *Id.*

406. David M. Stuart, & Charles F Wright, *The Sarbanes-Oxley Act: Advancing the SEC's Ability to Obtain Foreign Audit Documentation in Accounting Fraud Investigations*, 2002 COLUM. BUS. L. REV. 749, 776.

407 Johnson, *supra* note 396.

408. *Id.*

409. Brooke A. Masters, *Ahold Problems Go Beyond Foodservice*, WASH. POST, Mar. 1, 2003, at E1.

410. *Id.*

411. *Id.*

412. Robert J. McCartney, *Dutch Exchange is Investigating Giant Food' Parent*, Wash. Post, Feb. 27, 2003, at E1.

413. *Id.*, Brooke A. Masters & Robert J. McCartney, *Ahold Reported Scandal to Prosecutors*, WASH POST, Feb. 27, 2003, at E1

414. Gregory Crouch & Suzanne Kapner, *Royal Ahold Confirms U.S. Inquiries Into Its Accounting*, N.Y TIMES, Feb. 26, 2003, at C2.

# How the Europeans Stack Up

***Britain led the pack last year when consultant Deminor ranked West European countries on three broad measures of corporate governance****

| COUNTRY | SHAREHOLDER RIGHTS | DISCLOSURE | BOARD STRUCTURE | TOTAL |
|---|---|---|---|---|
| BRITAIN | 4 | 5 | 5 | 14 |
| FRANCE | 4 | 3 | 3 | 10 |
| ITALY | 3 | 4 | 3 | 10 |
| GERMANY | 4 | 3 | 2 | 9 |
| NETHERLANDS | 2 | 3 | 3 | 8 |
| SPAIN | 2 | 2 | 4 | 8 |
| SWITZERLAND | 2 | 2 | 2 | 6 |

*Based on analysis of FTSE Eurotop 300 companies.
1=worst and 5=best Data: Deminor

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415. Capell, *supra* note 333.

## CONCLUSION

While U.S. Corporations have been under pressure to adopt more independent boards since the 1970s, the corporate scandals and subsequent Sarbanes-Oxley Act have added substantially to that pressure. Independence may be one factor among several vital to reforming corporate governance, but it is certain that many corporate boards are changing, especially in their scrutiny of CEOs and top management. Business groups and leaders have criticized the Sarbanes-Oxley Act for going too far and adding needless expenses to conducting business, especially in the standards and documentation of internal controls, while making it more difficult to attract talented directors to govern the corporation. Meanwhile, business critics contend the law falls short even in the area of accounting reform, where it is most directed, and ignores other important areas of corporate governance. Still, most acknowledge it is the most important corporate reform legislation since the Securities and Exchange Act of 1933, and its impact is bolstered by shareholder activism and litigation, by state and federal regulatory authorities, by increased penalties and criminal prosecutions, and by more aggressive stock exchanges.

The rise in concern over corporate governance is also occurring on a global basis, taking on forms both similar to and different from those in the U.S. Some countries take a stronger stakeholder approach than does the U.S., but shareholder activism is becoming more common even in countries that do not share the American history of capitalistic democracy. Further, in the U.K., governance reform and shareholder empowerment has advanced in some ways even more than it has in the U.S. Hopefully, this global movement will deter management misconduct and elevate investor confidence in the future, thereby enhancing the prospects for global economic expansion.

# THE ALIEN TORT CLAIMS ACT & *DOE V UNOCAL*. A *PAQUETE HABANA* APPROACH TO THE RESCUE

JOHN HABERSTROH*

*The requirement that a rule command the general assent of civilized nations to become binding upon them all is a stringent one. Were this not so, the courts of one nation might feel free to impose idiosyncratic legal rules upon others, in the name of applying international law.*[1]

*The exalted power of administering judicially the law of nations What a beautiful and magnificent prospect of government is now opened The sluices of discord, devastation, and war are shut: those of harmony, improvement, and happiness are opened.*[2]

## I. INTRODUCTION

Twenty years ago Judge Edwards made his now well-known plea for the Supreme Court to clarify the Alien Tort Claims Act" (ATCA)[3] and the law of nations.[4] His plea echoes through a series of recent Ninth Circuit alien tort claim

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1. Filartiga v. Pena-Irala, 630 F.2d 876, 881 (2d Cir. 1980) (quoting The Paquete Habana, 175 U.S. 677 694 (1900)).

2. 1 JAMES WILSON, *Of Man, as Member of the Great Commonwealth of Nations*, *in* THE WORKS OF JAMES WILSON 282 (Robert G. McCloskey ed., 1967), *quoted in* Douglas J. Sylvester, *International Law As Sword Or Shield? Early American Foreign Policy and the Law Of Nations*, 32 N.Y.U. J. INT'L L. & POL. 1, 60 (1999); *See also* William R. Casto, *The Federal Courts Protective Jurisdiction Over Torts Committed in Violation of the Law of Nations*, 18 CONN. L. REV 467, 505 (1986).

3. 28 U.S.C.A. § 1350 (West 2004). ATCA is not an "Act". Alien Tort Statute is a more accurate but less widely used designation. *See, e.g.*, Curtis A. Bradley, *Universal Jurisdiction and U.S. Law*, 2001 U. CHI. LEGAL F 323, 342 (2001) (discussing the Alien Tort Statute). Others would prefer the statute be called the Alien Tort Clause, since it was in fact a clause in Section 9 of the Judiciary Act of 1789. William S. Dodge, *The Historical Origins of The Alien Tort Statute: A Response to the "Originalists* 19 HASTINGS INT'L & COMP L. REV. 221, 222 n.6 (1996) [hereinafter Dodge I].

4. Tel-Oren v. Libyan Arab Republic, 726 F.2d 774, 775 (D.C. Cir. 1984) (Edwards, J., concurring) ("This case deals with an area of the law that cries out for clarification by the Supreme Court. We confront at every turn broad and novel questions about the definition and application of the 'law of nations.'"). Judge Robb disagreed in the same per curiam decision:

> When case presents broad and novel questions of this sort, courts ought not to appeal for guidance to the Supreme Court, but should instead look to Congress and the

decisions here labeled *Unocal I*, *II*, and *III*.[5] The litigation concerns Unocal's alleged complicity in Burmese security forces' use of forced labor to construct oil and gas pipeline facilities. *Unocal III* is a vacated appellate court decision, recently reheard en banc.[6] A final Ninth Circuit decision was expected in the Fall of 2003, but a decision had not yet been issued by the following spring.[7]

A rehearing decision that largely affirms the appellate court may compel Supreme Court review, and then we may have the long overdue update of judicial rules for determining customary international law.[8] This in turn would clarify which international human rights violations, and which behavior in complicity with those violations, fall within the scope of ATCA.[9]

The Ninth Circuit en banc oral arguments took place on June 17 2003. As expected, the judges' main interest was whether the appellate court was correct in submitting Unocal's actions to an aiding-and-abetting standard derived from *ad*

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President. Should these branches of the Government decide that questions of this sort are proper subjects for judicial inquiry, they can then provide the courts with the guidelines by which such inquiries should proceed.

*Id.* at 827 (Robb, J., concurring). The terms "customary international law" and "the law of nations" are treated here as equivalent. *See* Sideman de Blake v. Argentina, 965 F.2d 699, 714 (9th Cir. 1992) ("[C]ustomary international law [is] the direct descendant of the law of nations."); Doe I v. Islamic Salvation Front, 993 F Supp. 3, 7 (D. D.C. 1998) ("The law of nations [is] currently known as international customary law.").

5. Doe v. Unocal Corp. 963 F Supp. 880 (C.D. Cal. 1997) [hereinafter *Unocal I*]; Doe v. Unocal Corp. 110 F Supp. 2d 1294 (C.D. Cal. 2000) [hereinafter *Unocal II*]; and Doe v. Unocal Corp, Nos. 00-56603, 00-57197, 2002 U.S. App. LEXIS 19263 (9th Cir. Sept. 18, 2002) [hereinafter *Unocal III*].

6. Doe v. Unocal Corp., Nos. 00-56603, 00-57197, 2003 U.S. App. LEXIS 2716 (9th Cir. Feb. 14, 2003) (en banc hearing order). *See also* Jason Hoppin, *9th Circuit Wrestles With ATCA Standards*, THE RECORDER, June 18, 2003, *available at* http://www.law.com/jsp/newswire_article.jsp?id=1055463665626 (last visited Mar. 10, 2004). An unofficial transcript of the en banc hearing is provided by one of the non-government organizations (NGOs) assisting the plaintiffs, Earthrights International. *See* http://www.earthrights.org/unocal/enbanctranscript.doc (last visited Mar. 10, 2004). For further information on the NGOs assisting the plaintiffs, see *infra* note 22 and accompanying text.

7 *See* Harold H. Koh, *Wrong on Rights*, YALE GLOBAL ONLINE, July 18, 2003, *at* http://yaleglobal.yale.edu/display.article?id=2121 (last visited Mar. 10, 2004).

8. "Customary international law [is the law of the international community] that results from a general and consistent practice of states followed by them from a sense of legal obligation. RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAW OF THE UNITED STATES § 102(2) (1987); *cf.* Charter of the United Nations and Statute of the International Court of Justice, June 26, 1945, art. 38(1)(b), 59 Stat. 1031, 1060, 1945 U.S.T LEXIS 199, 63 (stating that the Court shall apply "international custom, as evidence of a general practice accepted as law").

9. For this reason, the now seven years of litigation have been closely watched by allies of international corporations and human rights advocates. *See* Marcia Coyle, *9th Circuit Spurns U.S. Over Alien Tort Claims*, NAT'L L. J., June 10, 2003, *available at* http://www.law.com/servlet/ContentServer?pagename=OpenMarket/Xcelerate/View&c=LawArticle&cid=1052440857507&t=LawArticle (last visited Mar. 10, 2004) (writing that *Doe v. Unocal* is "viewed as pivotal by human rights and corporate defense lawyers in the fight over ATCA."); Jenna Greene, *Gathering Storm*, LEGAL TIMES, July 23, 2003, *available at* http://www.law.com/jsp/newswire_article.jsp?id=1058416406911 (last visited Mar. 10, 2004) (Greene writes that the case is closely watched. Regarding ATCA, she states that "[b]usiness advocates nationwide are sounding the alarm about the once-obscure 1789 statute with "[g]round zero in the fight *Doe v. Unocal*." She adds that "[l]abor and human rights activists, religious groups, environmental organizations and plaintiffs' lawyers are mobilized to defend the statute ").

*hoc* international criminal tribunal decisions.[10] The judges indicated they were considering the *Unocal III* concurrence, which had suggested instead applying a federal civil common law standard to the aid-and-abet claims.[11]

However, by presenting itself with only those two choices, the appellate court displayed the unpalatable alternatives U.S. courts normally provide themselves with in making customary international law determinations. A third and better alternative is to institute a judicial practice – in a substantive international law matter such as the applicable aiding-and-abetting standard – of freshly determining such standards from the consensus among the world's domestic legal systems. This might be called a "*Paquete Habana*" approach, though it is a natural extension of *Habana* in line with the increased scope and domestic penetration of international law. Critically such an approach would continue to recognize the consensual nature of customary international law· that it must derive from settled practice among the nations of the world. As applied to Unocal's aiding and abetting conduct – which would not generate civil or criminal liability in the vast majority of the world's legal systems – the approach would not find the corporation's misbehavior a law of nations tort, and would compel dismissal of the action because ATCA subsumes only torts in violation of customary international law.

ATCA itself may receive a fresh review if the Supreme Court considers *Unocal III*. Concerned by a statute unbound by a "new" customary international law, the Court may seek to dim the statute's usefulness in international human rights litigation.[12] The Court may even align itself with the scholarship of Judge Robert Bork and others who have long advocated limiting ATCA to law of nations torts actionable in the 1790s or to torts taking place in the United States.[13] Instead,

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10. *Doe v. Unocal Corp.*, Nos. 00-56603, 00-57197, 2003 U.S. App. LEXIS 2716 (9th Cir. Feb. 14, 2003) (en banc hearing order).

11. *Id.*

12. *See* Curtis A. Bradley, *The Status of Customary International Law in the U.S. Courts – Before and After Erie*, 26 DENV. J. INT'L L. & POL'Y 807, 822 (1997) (A critic of the new customary international law, Bradley states that it "differs from traditional customary international law in several fundamental ways: it can arise much more quickly; it is based less on actual state practice and more on international pronouncements, such as UN General Assembly resolutions and multilateral treaties; and, perhaps most importantly, it purports to regulate not the relations of states among themselves, but rather a state's treatment of its own citizens."); *see also* J. Patrick Kelly, *The Twilight of Customary International Law*, 40 VA. J. INT'L L. 449, 536 (2000) (concluding that customary international law lacks the four indicators of legitimacy: determinacy, symbolic validation, coherence, and adherence to hierarchy of secondary rules); Jack L. Goldsmith & Eric A. Posner, *Understanding the Resemblance Between Modern and Traditional Customary International Law*, 40 VA. J. INT'L L. 639, 666-68 (2000); Louis Henkin, *Human Rights and State "Sovereignty* 25 GA. J. INT'L & COMP L. 31, 38 (1995-1996) (arguing that binding international human rights norms can be discovered through examination of liberal national constitutions, and are "not based on state practice at all").

13. *See Tel-Oren*, 726 F.2d at 810-16 (Bork, J., concurring); Alfred P Rubin, *Professor D'Amato Concept of American Jurisdiction is Seriously Mistaken*, 79 AM. J. INT'L L. 105, 105-06 (1985). The *Doe v. Unocal* defendants and the Department of Justice showed their sympathies in briefs submitted to the en banc panel reviewing the case. Both featured as their main arguments Bork's position that ATCA does not provide a cause of action. Supplemental Brief of Defendants-Appellees, Doe v. Unocal, filed April 23, 2003, *available at* http://www.unocal.com/myanmar/enbanc_brief (last

with a modernized *Paquete Habana*, the Court should resist Bork's historically inaccurate position but at the same time reject the new, non-consensual, non-positivist customary international law

After briefly describing the human rights violations in Burma that gave rise to litigation against Unocal, this paper begins to connect ATCA with those wrongs by examining the early history of the alien tort statute, particularly its original purpose. The paper finds that early history generally in harmony with the statute's revival in modern international human rights litigation, which includes the *Unocal* litigation. The paper begins discussion of the modern era with *Filartiga v. Pena-Irala*, an offspring of the birth of modern international human rights law in the Nuremberg Tribunal. The discussion of ATCA concludes by reviewing the controversy surrounding Judge Bork's opinion in the Tel-Oren decision, and finds the *Filartiga* human rights litigation tradition more compatible with an originalist understanding of ATCA than Judge Bork's ATCA scholarship.

Finally the paper examines the *Unocal* litigation, particularly the *Unocal III* decision, which employed a notion of customary international law that appears to escape the boundaries of the *Filartiga* tradition, deriving its legal standards inappropriately from Nuremberg-style ad hoc criminal tribunals. Such a practice inaccurately suggests that the tribunals have established a customary international law independent of the practice of sovereign states and their legal systems. A common-sense examination of choice of law principles suggests the *Paquete Habana* methodology be applied not merely to primary violations of customary international law, such as the forced labor allegations against the Myanmar military government, but also to substantive legal issues ancillary to the primary ones, in this instance the third-party complicity standard to be applied to Unocal's behavior.

## II. HUMAN RIGHTS VIOLATIONS IN BURMA

The *Unocal* decisions concern a class action suit brought by farmers from the Tenasserim region of Burma, also internationally recognized as Myanmar, against, among others, Unocal Corp. ("Unocal"), Total S.A. ("Total"), and Burma's

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visited Feb. 2, 2004); Brief for the United States of America As Amicus Curiae, May 8, 2003, *available at* http://www.unocal.com/myanmar/doj/pdf (last visited Feb. 16, 2004). The plaintiffs filed a response to the Department of Justice brief. Plaintiffs-Appellants Supplemental Brief in Opposition to Amicus Curiae Brief Filed by the United States, filed June 2, 2003, *available at* http://www.ccr-ny.org/v2/legal/corporate_accountability/docs/OppositionBrieftoDOJ.pdf (last visited Feb. 16, 2004). At the en banc hearing, Ninth Circuit judges showed little interest in the approach to ATCA taken by Judge Bork. *See* Hoppin, *supra* note 6 ("Several times when [Unocal lawyer M. Randall Oppenheimer] was asked about aiding and abetting standards, he responded with the caveat that he was only engaging the question hypothetically, since he believes the case cannot be brought under the ATCA. The judges seemed to pay little mind to his protestations."). *See also* Coyle, *supra* note 9 (noting that the en banc 9th Circuit – in its June, 2003 Alvarez-Machain v. U.S., No. 99-56772, and Alvarez-Machain v. Sosa, No. 99-56880 decisions ignored the Justice Department's argument that ATCA does not create a cause of action and therefore does not allow aliens to bring claims for conduct taking place in other countries).

military government.[14] The farmers alleged that the Burmese military had committed international human rights violations through a state-owned oil and gas company in furtherance of a Unocal, Total, and Burmese military joint venture, the Yadana gas pipeline project.[15] The Burmese military and security forces allegedly used the farmers as slave labor for the pipeline project, and raped, tortured and murdered those who refused to participate.[16] Plaintiffs alleged that Unocal and Total, by using the services of the Burmese security forces with some awareness of their practices, had used the Burmese farmers as slave labor for the pipeline project.[17] Successive Burma regimes have a "long and well-known history of imposing forced labor on their citizens."[18]

The Unocal litigation originated with a Burmese trade union leader, U Maung Maung, and his serendipitous contact with a Georgetown law school student, Douglas Steele.[19] U Maung Maung, an exile in Thailand, was dismayed by the flood of refugees escaping from Burma who told him of forced labor and associated rape, torture and murder on the Unocal-Total pipeline project.[20] He wondered aloud to Steele whether any action could be brought against Unocal in U.S. courts, and Steele investigated.[21] Steele ultimately contacted the International Labor Rights Fund in Washington, D.C.,[22] which then filed a claim against Unocal in September 1996.[23] The claim was the first ATCA-based international human rights action against a U.S. corporation.[24]

## III. THE ALIEN TORT CLAIMS ACT, FROM INTENT TO REVIVAL

### *A. Original Intent and Early History*

A legal understanding of the case brought against Unocal must begin with an

14. Burma's military government is called the State Law and Order Restoration Council. *Unocal I* and *Unocal II* use the acronym SLORC. *Unocal II*, 110 F Supp. 2d at 1296; *Unocal I*, 963 F Supp. at 883. *Unocal III* instead uses the term "the Myanmar military. *Unocal III*, 2002 U.S. App. LEXIS 19263 at 3.

15. *Unocal I*, 963 F Supp. at 883.

16. *Id.*

17 *Id.*

18. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 4.

19. *See* Terry Collingsworth, *The Key Human Rights Challenge: Developing Enforcement Mechanisms*, 15 HARV. HUM. RTS. J. 183, 187 (2002).

20. *Id.* (U Maung Maung was General Secretary of the Federation of Trade Unions of Burma (FTUB).).

21. *Id.* (Steele was working as a legal intern for an advisor to the FTUB.).

22. The International Labor Rights Fund website is www.laborrights.org. Two other NGOs assisting the plaintiffs are EarthRights International of Washington, D.C. and Chiang Mai, Thailand, whose Unocal webpage is at http://www.earthrights.org/unocal/index.shtml, and New York's Center for Constitutional Rights, whose *Doe v. Unocal* webpage is http://www.ccr-ny.org/v2/legal/corporate_accountability/corporateArticle.asp?ObjlD=lrRSFKnmmm&Content=45 (last visited Mar. 10, 2004).

23. *See* Collingsworth, *supra* note 19, at 187.

24. *Id.*

understanding of ATCA, but based on more than the statute's reasonably clear wording. ATCA, adopted in 1789 and codified at 28 U.S.C. § 1350, declares that the federal district courts have "original jurisdiction of any civil action by an alien for a tort only, committed in violation of the law of nations or a treaty of the United States."[25] The statute, from its wording, allows a civil action to be brought in federal courts (1) by an alien (2) for a tort (3) committed in violation of international law. Who can be sued is not limited, and therefore might include aliens as well as U.S. citizens.[26]

However, the statute's rare use before its human rights litigation revival – only twenty-one cases had invoked jurisdiction under ATCA before 1980[27] – made courts and scholars anxious that revived usage accord with the statute's original meaning and purpose.[28] Thus, courts have strived to interpret ATCA in light of Judge Learned Hand's counsel that "statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning."[29]

Yet the statute was once famously declared "a kind of legal Lohengrin,"[30] and a complete account of its purpose and object may not be possible. For example, there is no record of discussions in Congress leading up to ATCA s enactment.[31] Nonetheless, many windows into Congressional thinking are available, and the origins and general purposes of ATCA turn out to be reasonably clear.[32] First of

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25. 28 U.S.C. § 1350.

26. The class of defendants would, in time, be restricted to aliens alone, though neither the statute nor the limited early case law implies such a restriction. *See* Dodge I, *supra* note 3, at 222 n.6.

27 *See* Kenneth C. Randall, *Federal Jurisdiction over International Law Claims: Inquiries into the Alien Tort Claims Statute*, 18 N.Y.U. J. INT'L L. & POL. 1, 4-5 n.15 (1985).

28. *See* Anne-Marie Burley, *The Alien Tort Statute and the Judiciary Act of 1789: A Badge of Honor* 83 AM. J. INT'L L. 461, 463 (1989) ("The current debate over the meaning and scope of the Statute is being waged on historical turf. An original intent argument may seem particularly attractive because the Statute virtually lay fallow for 200 years.") (Anne-Marie Burley would later change her name to Anne-Marie Slaughter). For thorough examinations of ATCA's background and historical context, see the concurring opinions of Judge Bork and Judge Edwards in *Tel-Oren v. Libyan Arab Republic*, 726 F.2d 774 (D.C. Cir. 1984).

29 Cabell v. Markham, 148 F.2d 737, 739 (2d Cir. 1945).

30. IIT v. Vencap, 519 F.2d 1001, 1015 (2d Cir. 1975) (stating that "although it has been with us since the first Judiciary Act no one seems to know whence it came."). Lohengrin, legendary figure depicted in the Wagner opera of the same name, was mysterious knight who refused to reveal his full identity to his bride. *See* Courtney Shaw, Note, *Uncertain Justice: Liability of Multinationals under the Alien Tort Claims Act*, 54 STAN. L. REV 1359, 1365 n.33 (2002).

31. *See* Ivan Poullaos, *The Nature of the Beast: Using the Alien Tort Claims Act to Combat International Human Rights Violations*, 80 WASH. U. L.Q. 327, 329 (2002); *Tel-Oren*, 726 F.2d at 812 (Bork, J., concurring) (citing 1 ANNALS OF CONG. 782-833 (J. Gales ed., 1789)) ("The debates over the Judiciary Act in the House—the Senate debates were not recorded—nowhere mention the provision, not even, so far as we are aware, indirectly.").

32. *See* Randall, *supra* note 27, at 11 ("True, no specific legislative history exists on the Judiciary Act; but other historical and legislative sources, when pieced together, adequately indicate the statute's origins and purposes."); William S. Dodge, *The Constitutionality of the Alien Tort Statute: Some Observations on Text and Context*, 42 VA. J. INT'L L. 687, 692 n.27 (2002) [hereinafter Dodge II] (declaring that, in the wake of considerable legal historical research, "it is fair to say that the Alien Tort Statute is no longer 'legal Lohengrin' ").

all, and broadly, it is evident the statute was a product of an effort by a militarily weak nation reliant on international commerce to gain control over its voice in foreign relations.[33] One element of that voice was treatment of tort actions by foreigners for international law violations.[34]

Scholarly disagreement arises when discussion moves from general to more specific purposes for the statute. Scholars pose two specific purposes (both will be discussed in detail shortly). First, many see a "defensive" purpose: ATCA was conceived as a defensive measure to remove a potential cause for international conflict with the U.S. from the diplomatic arsenal of aggressive mercantile powers.[35] A second viewpoint is that the statute has an "assertive" purpose: ATCA was a by-product and expression of a struggle by neutrals for "free trade" with belligerent nations during an era of near constant war.[36] The United States took up this campaign alongside other militarily weak nations dependent on international commerce, and the battle was waged by means of moral persuasion; there was little else to work with against the mercantile world powers.[37] The moral character of the struggle made it both natural and strategic to remove resolution of international law disputes, including alien tort suits, from the "interested" political branches to the loftier realm of the judiciary.[38] The judiciary's job, after all, was to detect, define and interpret natural law and morality, and the federal judiciary could best be expected to establish a uniform and prominent national position on the law of nations in accord with and supportive of U.S. policy and commercial interests.[39]

Actually, there need be no real disagreement over ATCA's specific purposes: the two objectives described are both compatible and supported by substantial historical evidence.[40] Therefore, this paper will proceed under the well-supported

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33. Banco Nacional de Cuba v. Sabbatino, 376 U.S. 398, 427 n.25 (1964) (describing ATCA as one of several provisions in the Judiciary Act "reflecting a concern for uniformity in this country's dealings with foreign nations and indicating desire to give matters of international significance to the jurisdiction of federal institutions"); *see also* Randall, *supra* note 27, at 72 ("[T]he federal government's plenary authority over matters touching foreign relations motivated the statute's promulgation.").

34. *See Tel-Oren*, 726 F.2d at 812 (Bork, J., concurring) ("[T]hose who drafted the Constitution and the Judiciary Act of 1789 wanted to open federal courts to aliens for the purpose of avoiding, not provoking, conflicts with other nations."); Randall, *supra* note 27 at 72 ("[T]he statute's origin and purpose are linked to the drafters' concern with extending federal authority over certain tort actions brought by aliens where federal jurisdiction might otherwise have been unavailable "); *see generally* Dodge I, *supra* note 3 (discussing the treatment of foreign tort actions for international law violations).

35. *See, e.g.*, Stewart Jay, *The Status of the Law of Nations in Early American Law*, 42 VAND. L. REV. 819, 840 (1989) ("At the practical level, the need to avoid violation that would give more powerful country cause for war explained the insistence on following the law of nations."); Anthony D'Amato, *The Alien Tort Statute and the Founding of the Constitution*, 82 AM. J. INT'L L. 62, 64 (1988).

36. *See generally* Sylvester, *supra* note 2. Sylvester's thesis will be more thoroughly explored later in this subsection.

37 *See id.*

38. *See id.*

39 *See id.*

40. Sylvester, the scholar who makes the case for the assertive purpose, acknowledges that both purposes exist: "Legal historians and scholars alike believe that the law of nations was used as a shield.

supposition that ATCA had both defensive *and* assertive purposes. The comparative priority Congress gave to those two goals remains uncertain, yet this is not critical for a modern understanding of ATCA in the human rights litigation context.

However, in order to gain the best possible understanding of Congressional intent and how it might fit with use of the statute for redress of international human rights violations, a more detailed grasp of the background and context of the statute and its purposes is necessary Regarding the "defensive" purpose, in 1789 a powerful enemy could interpret denial of an adequate judicial forum to an alien tort claimant as official approval of the wrongful tort against the alien, and, consequently as an affront to the foreigner's home country [41] Emmerich de Vattel, the most influential international law scholar in the early days of the United States, specifically stated that "denial of justice" to aliens abroad was one justification for initiation of a war of reprisal by the foreign national's home country [42] Consequently, before ATCA, if a state court mishandled an alien tort claim – with no federal influence over that forum and no judicial alternative provided for the alien – the incident could readily be transformed into a transnational insult, drawing the United States into a war or lesser international incident.[43] Therefore, a standard contention is that ATCA's primary attraction was its assurance against, or at least maximization of federal control over, such a scenario.[44] As Alexander Hamilton commented in the Federalist Papers, "[a]s the denial or perversion of

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A proper understanding of the period demonstrates that it was used just as often as sword to achieve specific policy goals of the young country. *Id.* at 7 For further discussion of the defensive purpose, see D'Amato, *supra* note 35, at 64.

41. Kathryn L. Pryor, *Does the Torture Victim Protection Act Signal the Imminent Demise of the Alien Tort Claims Act?* 29 VA. J. INT'L L. 969, 971 (1989).

42. *See* D'Amato, *supra* note 35, at 64. The quotation is from 2 EMMERICH DE VATTEL, THE LAW OF NATIONS 230-31 (Charles G. Fenwick trans., Carnegie Institute of Washington 1916) (1758). Although on this matter he reflected a wide consensus, Vattel was less influential in France and Britain than he was among the militarily weak trading nations. *See generally* Dennis R. Nolan, *Sir William Blackstone and the New American Republic: A Study of Intellectual Impact*, 51 N.Y.U. L. Rev. 731 (1976) (discussing Blackstone's influence on the Founders.).

43. Pryor, *supra* note 41, at 972. *See also Tel-Oren*, 726 F.2d at 783 (Edwards, J., concurring):

> Under the law of nations, states are obliged to make civil courts of justice accessible for claims of foreign subjects against individuals within the state's territory If the court's decision constitutes a denial of justice, or if it appears to condone the original wrongful act, under the law of nations the United States would become responsible for the failure of its courts A private act, committed by an individual against an individual, might thereby escalate into an international confrontation.

*Id.*

44. *See* D'Amato, *supra* note 35, at 63:

> ATCA's original, overriding purpose was to maintain a rigorous neutrality in the face of the warring European powers. The United States was still weak militarily, compared to England, France and Spain. Many years would be needed before the new nation could stand firm against any aggressive threat from abroad. During the formative years of buildup, it was imperative that no excuse, no casus belli, be given to a foreign power.

*Id.*, *see also* The Federalist No. 80, at 476 (Alexander Hamilton) (Clinton Rossiter ed., 1961) *quoted in* Dodge I, *supra* note 3, at 236 [hereinafter The Federalist No. 80]. The Federalist Papers were originally published in 1787 and 1788.

justice by the sentences of courts, as well as in any other manner, is with reason classed among the just causes of war, it will follow that the federal judiciary ought to have cognizance of all causes in which the citizens of other countries are concerned."[45] Before long, ATCA would provide such federal cognizance over torts in violation of international law.

One "defensive" concern vis-a-vis the Great Powers of the day involved state courts' refusal to enforce treaties between the federal government and foreign nations.[46] Of particular concern, the treaty ending the Revolutionary War promised payment of debts to British creditors, but in fact state courts often blocked Britain's efforts to collect the debts.[47] As a result, Britain repeatedly threatened reprisals, which jeopardized U.S. security.[48] ATCA could have provided a means of redress, because treaty violation injuries were torts in violation of the law of nations.

Further examples of the federal powerlessness the new Congress wanted to alleviate with ATCA include two 1780s violations of diplomatic privileges. The better-known "Marbois Affair" concerned a 1784 threat and assault upon French Consul General Francis Barbe Marbois in Philadelphia.[49] An international clamor ensued, the case was widely discussed among key federal figures, and Congress stepped in to offer a reward for capture of the French assailant, Chevalier De Longchamps.[50]

However, the federal government could do no more because it did not have judicial jurisdiction over the crimes or torts in violation of international law This inadequacy was of wide concern, and in 1785 the Continental Congress was forced to explain to Marbois that federal powers were confined by "the nature of the federal union in which each State retains a distinct and absolute sovereignty in all matters not expressly delegated to Congress leaving them only that of advising in many of those cases in which other governments decree."[51]

From the national perspective, Pennsylvania handled Longchamp's criminal prosecution well: he was tried and convicted of violating the law of nations, which was held to be part of Pennsylvania common law.[52] A civil action was not available to aliens under Pennsylvania law – the state had disregarded a 1781 Congressional resolution asking that such redress be made available by the states[53]

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45. The Federalist No. 80, *supra* note 44, at 476. Note that such purpose for ATCA indicates it can be used against foreign as well as U.S. nationals when a "law of nations" tort is committed. *See* Dodge I, *supra* note 3, at 222.

46. Beth Stephens, *Federalism and Foreign Affairs: Congress Power To "Define and Punish Offenses Against the Law of Nations* 42 WM. & MARY L. REV. 447, 466 (2000).

47 *Id.* at 466-67.

48. *Id.* at 467.

49. The details of the story are not in dispute. This summary is drawn from Dodge I, *supra* note 3, at 229-30 and Dodge II, *supra* note 32, at 693-95.

50. *See* Dodge I, *supra* note 3, at 229-30; Stephens, *supra* note 46, at 466.

51. 27 JOURNALS OF THE CONTINENTAL CONGRESS, 1774-1789, at 314 (Library of Congress ed., 1912), *quoted in* Dodge I, *supra* note 3, at 229-30.

52. Dodge I, *supra* note 3, at 230.

53. *See* Dodge II, *supra* note 32, at 692-93; Dodge I, *supra* note 3, at 229-30.

– and no tort suit was filed in the affair.[54]

The other display of federal inability to punish a violation of diplomatic privileges occurred in 1788, when a New York City police officer entered Dutch ambassador Van Berckel's residence and arrested one of his servants.[55] Secretary Jay complained that the federal government apparently was not vested "with any judicial Powers competent to the Cognizance and Judgment of such Cases."[56] Fortunately for relations with Holland, a state court found the officer guilty of violating international law and sentenced him to three months in jail.[57]

Fears in Congress that other states would not handle law of nations violations as well as Pennsylvania had led to passage of a 1785 resolution asking Secretary of Foreign Affairs, John Jay "to report the draft of an act to be recommended to the legislatures of the respective states, for punishing the infractions of the laws of nations, and more especially for securing the privileges and immunities of public Ministers from foreign powers."[58] There is no record of Jay having prepared such a draft.

Perhaps Jay was discouraged by the feeble response to the 1781 Congressional recommendation mentioned in reference to the Marbois affair. That resolution had asked states to create criminal sanctions for certain international law violations against aliens, and to authorize "(1) tort suits by the injured party against the tortfeasor, and (2) suits by the United States against the tortfeasor to reimburse the United States for compensation paid to the injured party."[59] While the text of the resolution indicates the tortfeasor in the second case had to be a U.S. citizen, a Connecticut bill in response to the Congressional resolution went further and allowed such suits against "any Person or Persons whatsoever."[60] Unlike Connecticut, however, it appears many states did not follow up on Congressional urging that they provide for criminal sanctions and law suits against law of nations violators.[61]

The figure of Oliver Ellsworth ties the Congressional recommendations with the state and federal statutory acts. He was a member of the Continental Congress that passed the 1781 resolution asking states to enact laws allowing damage suits and establishing criminal sanctions for international law violations against aliens.[62]

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54. *See* Dodge II, *supra* note 32, at 694-95.

55. *See* Dodge I, *supra* note 3, at 230.

56. *See* 34 JOURNALS OF THE CONTINENTAL CONGRESS, 1774-1789, at 111 (Library of Congress ed., 1912), *quoted in* Dodge I, *supra* note 3, at 230.

57 *See* Dodge I, *supra* note 3, at 230.

58. 29 JOURNALS OF THE CONTINENTAL CONGRESS, 1774-1789, at 655 (Gaillard Hunt ed., 1912), *quoted in* Dodge II, *supra* note 32, at 694 n.39.

59. *See* Dodge II, *supra* note 32, at 692-93.

60. *See id.* at 693 (quoting 4 THE PUBLIC RECORDS OF THE STATE OF CONNECTICUT FOR THE YEAR 1782, at 157 (Leonard Woods Labaree ed., 1942)).

61. *See* Dodge II, *supra* note 32, at 694-95.

62. *See* Dodge I, *supra* note 3, at 228-29. The recommendation asked states to enact laws that would "authorise suits to be instituted for damages by the party injured, and for compensation to the United States for damage sustained by them from an injury done to a foreign power by citizen. Dodge II, *supra* note 32, at 692 (quoting 21 JOURNALS OF THE CONTINENTAL CONGRESS, 1774-1789, at

Ellsworth was also a member of the 1782 Connecticut General Assembly that responded as described above to the 1781 Congressional recommendation.[63] Finally, he was responsible for writing most of the Judiciary Act of 1789 including section 9.[64] The ATCA sub-section of section 9 gave district courts jurisdiction over suits brought by an injured alien against a tortfeasor for law of nations violations, in keeping with the 1781 recommendation and Connecticut law.[65]

In sum, ATCA achieves its defensive purpose through its perceived ability to placate foreign powers with the federal courts' more consistent and less biased stance toward foreigners, when compared to state courts.[66] Congress believed that federal courts were more likely to give to alien claims what the non-citizen's home country would regard as fair consideration. Federal courts would also be expected to be more sensitive to any U.S. national interests implicated by alien claims.[67]

It is important to note the joining together of crime and tort in the 1781 Congressional Resolution, the 1782 Connecticut law, and the 1789 Judiciary Act. Evident in the 1781 resolution, for example, was an intention to expand the nation's civil liability international law duties beyond the very limited scope set down by Blackstone.[68] Anne-Marie Burley argues the wider scope of redress recommended in the Resolution "was an entirely logical addition, implicitly recognizing that justice under the law of nations could require making the victim whole as well as punishing the transgressor."[69] The Judiciary Act of 1789 carried forward the concept of parallel civil and criminal sanctions for law of nations violations, granting federal courts jurisdiction over common-law crimes "cognizable under the authority of the United States" – which included crimes in violation of international law – alongside federal jurisdiction and a cause of action for alien tort claims.[70] Judiciary Act author Ellsworth appeared to suppose, quite reasonably, that there might be a variety of possible offenses against international

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1136-37 (Gaillard Hunt ed., 1912)).

63. *See* Dodge II, *supra* note 32, at 692-93. Dodge noted that the Connecticut statute allows suits by aliens for any tort, not just for torts in violation of the law of nations. *Id.* at 693 n.32.

64. *Id.* at 695.

65. *Id.* at 695-96.

66. *See Tel-Oren*, 726 F.2d at 782-83; *see also* Dodge I, *supra* note 3, at 235 (writing that among the factors motivating provision of the alien tort statute were "a desire for uniformity in the interpretation of the law of nations, and fear that state courts would be hostile to alien claims."). As matters turned out, due to gaps in Supreme Court appellate jurisdiction, federal judicial uniformity was not all it could have been. *See* Dodge I, *supra* note 3, at 235 n.101, William S. Dodge, *Congressional Control of Supreme Court Appellate Jurisdiction: Why the Original Jurisdiction Clause Suggests an "Essential Role* 100 YALE L.J. 1013, 1017 n.19 (1991).

67 Pryor, *supra* note 41, at 971.

68. Judge Blackstone saw law of nations violations primarily as crimes, but also wrote that civil liability was available under the law of nations in the form of restitution against a transgressor for violation of safe-conduct. *See* Dodge I, *supra* note 3, at 226 n.35 (citing 4 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 69-70 (1765)); *see also* Burley, *supra* note 28, at 477 n.74 (explaining that the "recommended authorization of tort suits exceeds the scope of the duty outlined by Blackstone, who refers only to criminal sanctions").

69. Burley, *supra* note 28, at 477.

70. *See* Dodge I, *supra* note 3, at 231 (quoting Judiciary Act, ch. 20, § 9, 1 Stat. 73, 76-77 (1789)).

law, some of which were best resolved by criminal sanctions, others by civil damages to the injured, and some by a combination of criminal and civil sanctions.[71]

As with the "defensive" purpose, there is also sufficient evidence for an "assertive" purpose for ATCA. That evidence, however, takes a more abstract turn, starting with the Founders' fondness for Vattel and "Continental" international law doctrine.[72] That doctrine was aligned with U.S. commercial and security interests and early leaders of the United States made it their own.[73] Furthermore, U.S. leaders wanted to lift up Continental doctrine against rival Anglo-French doctrine, or, more accurately, establish it against the Anglo-French opposition to Continental law of nations doctrine becoming the widely accepted international law [74] This provided an assertive purpose for ATCA, in the hope that it would promote and solidify international acceptance of Continental international law doctrine as *the* international law doctrine, by subjecting international tort conflicts to a consistent and "disinterested" U.S. judicial treatment which also happened to advance and establish Continental doctrine.[75]

The specific doctrinal concern of early U.S. leaders, in an era of near constant military conflict between France and Britain, was the degree to which international law would favor belligerent or neutral rights in commerce.[76] The Americans advocated an understanding of the law of nations that strongly favored neutral rights.[77] Vattel was the most prominent of the American "pantheon" of international law jurists promoting that conception.[78] In fact, early post-Colonial judicial decisions cited almost exclusively to five international law scholars from

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71. Burley, *supra* note 28, at 477

72. "The Continent" generally describes the European nations other than the two mercantile heavyweights, France and Great Britain.

73. Sylvester, *supra* note 2, at 66 ("To start, it must be understood that the American' theory of the law of nations was an adaptation of the Continental philosophies on the law of nations.").

74. *See* Sylvester, *supra* note 2, at 43-44, 66.

75. *See id.* at 30-31.

76. It was "an age of the basest diplomatic intrigue, of hostilities too rarely assuaged in periods of peace, and of the utmost ruthlessness in the conduct of hostilities. Edwin Dickinson, *Changing Concepts and the Doctrine of Incorporation*, 26 AM. J. INT'L L. 239, 241 (1932), *quoted in* Sylvester, *supra* note 2, at 5.

77 *See* Sylvester, *supra* note 2, at 37, 64.

78. Dickinson, *supra* note 76, at 259 n.132, *quoted in* Sylvester, *supra* note 2, at 67; *See also* Sean D. Murphy, *The U.S. Lawyer-Statesman At Times Of Crisis: A Look at Colonial America*, 95 AM. SOC'Y INT'L L. PROC. 99, 105 (2001) ("[I]n the thirty years after ratification of the Constitution, U.S. courts would turn to Vattel as their favorite authority on the theory of international law."); Jay, *supra* note 35, at 823 ("In ascertaining principles of the law of nations, lawyers and judges of [the post-colonial] era relied heavily on Continental treatise writers, Vattel being the most often consulted by Americans."). As Sylvester explained:

> Grotius, Bynkershoek, Wolff, Vattel, and Pufendorf formed the American pantheon of writers on the law of nations. According to Edwin Dickinson, early American judicial decisions implicating the law of nations cited almost exclusively to these Continental writers, and they were quoted quite frequently for propositions about the law of nations: in all, in the 1780s and 1790s, there were nine citations to Pufendorf, sixteen to Grotius, twenty-five to Bynkershoek, and a staggering ninety-two to Vattel.

Sylvester, *supra* note 2 at 67. The Dickinson reference is to Dickinson, *supra* note 76, at 259 n.132.

three nations – the Netherlands, Austria, and Denmark – which, like the United States, depended heavily on international trade for their economic prosperity were militarily weak, and were generally neutrals in wars between the mercantile powers.[79] "Not surprisingly, writes Douglas Sylvester, "their understandings of the law of nations heavily favored neutral rights at the expense of belligerent rights. In so doing, these writers envisioned an international society predicated on peaceful relationships forged through trade."[80]

The early leaders of the Republic were very much attracted to Vattel's vision of an international relations based on natural law guaranteeing security and the benefits of trade to all states large and small.[81] Under Vattel's international law standard, which he believed continental Europe already reflected, the concerted power of the entire community of nations would overcome any country that dared suppress the rights of another, both out of obligation and from realization of the commercial and security benefits of the rule of the law of nations.[82]

The new nation's leaders were idealistic enough to believe that successful promotion of Continental international law might allow U.S. relations with the world to stabilize into such a Vattelian system.[83] Thus, in the Republic's early years, the United States engaged in a "proactive foreign policy based not on simple nationalistic self-interest, but rather, based on promotion, through advancement of the Continental/American law of nations doctrine, of de-militarized, commerce-driven international relations.[84] Specifically the promotion of Continental doctrine derived from two central hopes of early American foreign policy· "first, that international commerce should be predicated on a theory of neutral rights and free trade, and second, that economic measures, not armed conflict, were the proper response to belligerence."[85]

These views conflicted with those of the dominant mercantile powers, England and France. In fact, Edmund Genet, minister of France to the United States in the early 1790s, belittled the international status of neutral rights as "diplomatic subtleties" and "aphorisms of Vattel and others."[86]

England more explicitly challenged what would later be the American position on neutral rights when it announced, in 1756, that the commerce of neutral

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79. *See* Sylvester, *supra* note 2, at 40-41.

80. *See id.* at 67.

81. *See* EMMERICH DE VATTEL, THE LAW OF NATIONS, at lxii (Joseph Chitty ed., 1863) (1758) ("A dwarf is as much man as a giant; small Republic is no less sovereign state than the most powerful kingdom."), *quoted in* Jay, *supra* note 35, at 840.

82. *See* Sylvester, *supra* note 2, at 41.

83. For an example of such idealism, see the Judge Wilson quotation at the beginning of this article.

84. Sylvester, *supra* note 2, at 41.

85. *Id.* at 43.

86. Sylvester, *supra* note 2, at 43 (quoting Letter from Thomas Jefferson to Gouverneur Morris, United States Minister to France (Aug. 16, 1793), *in* 6 THE WRITINGS OF THOMAS JEFFERSON 371, 379 (quoting Letter from Edmund Genet to Thomas Jefferson (June 22, 1793)) (Paul Leicester Ford ed., 1899)).

nations with belligerent states in wartime would be restricted to peacetime levels.[87] Continental theory and its U.S. advocates advanced the much more liberal neutral trading rights doctrine: that a neutral had an unrestricted right to trade with belligerents during a war. As Thomas Jefferson argued:

> [W]hen two nations go to war, those who chuse [sic] to live in peace retain their natural right to pursue their [commerce], to carry the produce of their industry, for exchange, to all nations, belligerent or neutral, as usual, to go and come freely without injury or molestation, and in short, that the war among others shall be for them as if it did not exist.[88]

U.S. advocates of Continental law of nations theory also favored the "free ships" doctrine, which precluded from seizure all goods found in a neutral vessel, including belligerent goods.[89] Under this understanding, if France, while at war with Great Britain, were to stop an American ship and find English goods on board, those goods would not be condemned as prize.[90]

In federal judicial decisions of the 1790s, neutral rights were occasionally a topic of contention and judges did advance Continental law of nations doctrine.[91] With international law within their control, Sylvester writes, "federal courts used their decisions to support the needs of a commerce-based system. In order to do this, the law of nations needed to strengthen commitments towards neutral trade—at the expense of belligerent rights."[92] Nonetheless, "it was only by rigorous application, even in cases against the specific interests of Americans, that these rights could hope to be vindicated in international relations."[93] ATCA's assertive purpose of promoting Continental doctrine on neutral rights and free trade fit into this overall strategy

Nonetheless, despite the statute's embodiment of the assertive and previously described defensive objectives, courts rarely dealt with ATCA. In the 1790s, only two cases and one U.S. Attorney General opinion are available for possible insight into the statute's original intent.[94] In the first case, *Moxon v. The Fanny*,[95] a 1793

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87 *See* Sylvester, *supra* note 2, at 45.

88. *Id.* at 44 (quoting Letter from Thomas Jefferson to Thomas Pinckney (Dec. 20, 1793), *in* 27 THE PAPERS OF THOMAS JEFFERSON 55 (Julian P Boyd ed., 1953)).

89. Sylvester, *supra* note 2, at 44 ("In the 1780s Congress codified [the free ships doctrine] into American law, and at least once this enactment formed the rule of decision in a case.").

90. *Id.* at 44. Prize is defined as the wartime capture of ships or cargo, by privateers and other forces of belligerent nations during time of war, and is "therefore liable to being condemned or appropriated as enemy property. BLACK'S LAW DICTIONARY 1218 (7th ed. 1999).

91. *See* Sylvester, *supra* note 2, at 31-36.

92. *Id.* at 64.

93. *Id.* at 35.

94. Dodge I, *supra* note 3, at 251. However, there are likely other cases or Attorney General opinions unrecorded or unpreserved. William Casto notes an early Attorney General opinion that does not explicitly mention ATCA but does refer to an ambassador prosecuting "an indictment in district court"· this appears to rely on the statute because an ambassador could not prosecute criminal suit. Casto, *supra* note 2, at 504 n.208 (discussing 1 Op. Att'y Gen. 141 (1804)).

95. Moxon v. Fanny, 17 F Cas. 942 (D. Pa. 1793)

district court denied federal court jurisdiction on political question grounds,[96] but stated in dicta that ATCA jurisdiction would have been denied even without the political question roadblock, because plaintiffs had sued for both restitution and for damages.[97] Therefore, they had not sued for a "tort only" as the statute demanded.[98]

The second case, *Bolchos v. Darrel*,[99] involved a French privateer's capture of slaves mortgaged to a Spanish citizen, where the mortgagee was a British citizen.[100] In port, the mortgagee's agent seized the slaves.[101] The privateer brought suit for the proceeds of the sale.[102] On an initial matter, the court claimed jurisdiction in the admiralty [103] It then added, on its jurisdictional right:

> Besides, as the 9th section of the judiciary act gives this court concurrent jurisdiction with the state courts and circuit court of the United States where an alien sues for a tort, in violation of the law of nations, or a treaty of the United States, I dismiss all doubt upon this point.[104]

The proceeding indicated that ATCA grants more than jurisdiction in the admiralty, and that the statute's grant is in fact the wide-ranging one indicated on its face.[105] In any event, though the court stated it would have restored the property to the neutral Spanish mortgagor under the law of nations, it ruled in favor of the French privateer because of a treaty between the U.S. and France stating that "the property of friends found on board the vessels of an enemy shall be forfeited."[106]

In 1795, the same year as *Bolchos*, ATCA was suggested as a remedy for victims of an attack on the British colony of Sierra Leone by a French fleet led by an American slave trader.[107] The British Ambassador officially protested, and doing nothing was not a safe response. However, if the United States paid

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96. *Id.*. at 946-47

97 *Id.* at 945.

98. Dodge I, *supra* note 3, at 252. As Dodge stated, the interpretation of the court was that "only" meant only one remedy for damages could be sought under ATCA, which meant the *Moxon* suit could have been made acceptable to the court simply by deleting from it the restitution claim. *Id.* This is contrary to another possible interpretation of "for a tort only" under which, if the events at issue give rise to types of claims in addition to tort claims, the federal court must refuse jurisdiction. *See* Joseph M. Sweeney, *A Tort Only in Violation of the Law of Nations*, 18 HASTINGS INT'L & COMP L. REV. 445, 482 (1995) (stating that ATCA was directed at captures of prize in which "the legality of the capture was not in issue, and the suit was 'only' for the reparation in damages of a wrong related to a capture"); *see also* Kadic v. Karadzic, 74 F.3d 377, 377-78 (2nd Cir. 1996) (rejecting Sweeney's restrictive interpretation of ATCA); Dodge I, *supra* note 3, at 243-56 (answering Sweeney's argument).

99. Bolchos v. Darrel, 3 F Cas. 810 (D. S.C. 1795).

100. *Id.* at 810.

101. *Id.*

102. *Id.*

103. *Id.*

104. *Id.*

105. This contrasts with Sweeney's restrictive claims regarding ATCA's applicability. *See* Sweeney, *supra* note 98, at 482.

106. *Id.* at 811.

107 D'Amato, *supra* note 35, at 66.

reparations directly to Great Britain surely France would have been angered.[108] "Fortunately the Founding Fathers had foreseen this very dilemma a half-dozen years earlier when they enacted the Alien Tort Statute, writes modern commentator Anthony D'Amato. Attorney General William Bradford issued an official opinion directing the British to the statute, which offered a solution especially felicitous for the United States since an ATCA suit by the British would have necessitated litigating from the standpoint of the Continental/American understanding of the law of nations.[109]

Then for 185 years activity dropped off considerably, for reasons that are uncertain.[110] One reason may have been that for most of those years the law of nations was understood to concern, with rare exception, affairs between nations and not between individuals and nations.[111] Also, the wider purposes of the statute rapidly fell away, as the U.S. effort to establish a Continental doctrine of neutral rights and free trade was overwhelmed by the need to accommodate the mercantile powers, France and Great Britain.[112]

The discussion of purposes and objects now complete, several implications of ATCA s original meaning and purpose appear relevant to the revival of the statute as a vehicle for international human rights actions. First of all, ATCA served a straightforward general purpose of advancing the national interest by putting a federal stamp on the law of nations, this having both defensive and assertive motivations. Second, and the historical context of the assertive objective especially puts this on view, Congressional leaders saw the statute as part of an effort to put the legal "voice" of the United States consistently behind one version of international law during a time of international conflict over the "true" law of

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108. *Id.*

109. Specifically, Bradford stated:

> [T]here can be no doubt that the company [the Sierra Leone company] or individuals who have been injured by these acts of hostility have remedy by a civil suit in the courts of the United States; jurisdiction being expressly given to these courts in all cases where an alien sues for a tort only, in violation of the laws of nations, or a treaty of the United States; such a suit may be maintained by evidence taken at a distance, on a commission issued for that purpose.

D'Amato, *supra* note 35, at 66 (quoting 1 Op. Att'y Gen. 57, 59 (1795)). Similarly, 1907 opinion of the Attorney General, regarding injuries caused by violation of a U.S. treaty covering the Rio Grande U.S.-Mexican border, stated that ATCA provided both jurisdiction and cause of action for the private Mexican citizens who wanted to sue. *See* 26 Op. Att'y Gen. 250 (1907), *discussed in* Randall, *supra* note 27, at 49-50.

110. Anne-Marie Slaughter, *Rogue Regimes and the Individualization of International Law*, 36 NEW ENG. L. REV. 815, 816 (2002).

111. *Id.* Although several exceptions have been widely accepted, the Westphalian formulation of relations between nations held that "what sovereign governments did within their own borders was of no concern to their neighbors. States were the subjects of international law; international law regulated only political and economic relations between states, not within them. *Id.*

112. The "fragile consensus" in the United States for pursuit, through non-military measures, of an international system based on neutral rights and free trade had been destroyed by 1809. Sylvester, *supra* note 2, at 55. "Unfortunately for the new country, without sufficient economic or military power to force adherence to neutral trading doctrines, this foreign policy was doomed to failure in the wake of the great conflicts of the 1790s and 1800s. *Id.* at 44-45.

nations doctrine. Therefore, the assertive purpose for the statute assumes the malleability of international law, since that purpose was to establish more firmly or to reform the law of nations advantageously for the United States. The nobler language of the day stated that international law had recently improved with the times,[113] and would conceivably develop further in the future.[114] The law of nations was understood as changeable, even though it was derived from and a subclass of immutable natural law, because it was a reflection of human reason's only gradual and imperfect progression in awareness of underlying natural law.[115] A third implication is that the apparent original understanding of the statute was that it might be employed in a wide variety of alien tort claims. Congress evidently meant what the statute's broad language says, and did not want ATCA only to be applied to a specific subclass of torts, for instance those ancillary to the capture of "prize."[116] Finally, and this awaits further exploration in the following sub-section, ATCA was originally understood to provide plaintiffs with both a general and specific cause of action.[117] This last matter became quite controversial early in the modern revival of ATCA as a vehicle for international human rights actions.[118]

### *B. The Filartiga Tradition: The Alien Tort Claims Act's Modern Revival*

Until 1980, only twenty-one cases had invoked jurisdiction under ATCA, and no one, human rights advocates included, had paid much attention to it.[119] In that year, however, a victim of crimes against humanity in Paraguay successfully used ATCA in a U.S. federal court.[120] Dr. Joel Filartiga, a Paraguayan physician who had arrived in the United States in 1978, alleged that Americo Peña-Irala was responsible for the torture and killing of Filartiga's seventeen-year-old son.[121] The

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113. Jefferson stated in 1793 that the principles of the law of nations "have been liberalized in latter times by the refinement of manners and morals *See* Sylvester, *supra* note 2, at 59 (quoting Letter from Thomas Jefferson to Thomas Pinckney (May 7, 1793), *in* 6 THE WRITINGS OF THOMAS JEFFERSON 243 (Paul Leicester Ford ed., 1899)). Further, Jefferson would write in 1816:

> [L]aws and institutions must go hand in hand with the progress of the human mind. As that becomes more developed, more enlightened, as new discoveries are made, new truths disclosed, and manners and opinions change with the change of circumstances, institutions must advance also, and keep pace with the times.

Letter from Thomas Jefferson to Samuel Kercheval (July 12, 1816), *in* 10 THE WRITINGS OF THOMAS JEFFERSON 42-43 (Paul Leicester Ford ed., 1899), *quoted in* Sylvester, *supra* note 2, at 59.

114. The decision in *Habana* was guided in part by just such progress in the law of nations. The question was whether fishing ships were protected by international law from capture during wartime. Though 1798 English case had stated such protection was a rule only of international comity, the Court held that "the period of hundred years which has since elapsed is amply sufficient to have enabled what originally may have rested in custom or comity, courtesy or concession, to grow, by the general assent of civilized nations, into a settled rule of international law. *Habana*, 175 U.S. at 694.

115. *See* 10 THE WRITINGS OF THOMAS JEFFERSON 42-43, *quoted in* Sylvester, *supra* note 112.

116. *See* Sweeney, *supra* note 98, at 482.

117 *See* Dodge I, *supra* note 3, at 237-40.

118. *See id.* at 221, 251.

119. *See* Randall, *supra* note 27, at 4-5 n.15.

120. *Filartiga*, 630 F.2d at 876.

121. *Id.* at 878.

Filartigas initiated legal action in Paraguay but their attorney was arrested, threatened with death by Peña-Irala, and disbarred without just cause.[122] In 1979 Peña-Irala was discovered living in the United States and held for deportation.[123] A federal court served a summons on him for wrongfully causing the death of Filartiga's son and plaintiffs sought to have the deportation enjoined to ensure Peña-Irala's availability for trial.[124] The legal action was brought principally under the jurisdiction of ATCA.[125] A lower court dismissed the complaint for lack of subject matter jurisdiction, and during the appeal Peña-Irala was deported back to Paraguay.[126]

The lower court decision was reversed in favor of Filartiga by appellate judge Irving R. Kaufman, who found ATCA applicable in its provision for federal court jurisdiction.[127] Judge Kaufman held that "deliberate torture perpetrated under color of official authority violates universally accepted norms of the international law of human rights, regardless of the nationality of the parties. Thus, whenever an alleged torturer is found and served with process by an alien within our borders, § 1350 provides federal jurisdiction."[128] Overruling the lower court on another matter, Judge Kaufman stated that courts "must interpret international law not as it was in 1789 but as it has evolved and exists today among the nations of the world today."[129] On remand, Peña-Irala took no part in the case, and the court awarded punitive damages of $5 million each to Filartiga and his daughter.[130] The judgment was never collected.[131]

In the past two decades *Filartiga* has been used as a point of reference in over one hundred cases and ATCA has been utilized in several dozen U.S. human rights actions.[132] Nevertheless, it is still unclear how useful ATCA is or will be in enforcing international human rights claims. A straightforward concern, for example, continues to be the difficulty collecting damage awards.[133] In addition, it is not yet clear how heavily federal courts will burden ATCA-based human rights

122. *Id.*
123. *Id.* at 878-79.
124. *Id.* at 879.
125. *Id.*
126. *Id.*
127 *Id.* at 878.
128. *Id.*
129. *Id.* at 881. *See also* Kadic v. Karadzic, 70 F.3d 232, 238 (2d Cir. 1995) (citing Judge Kaufman's statement in *Filartiga*).
130. HENRY J. STEINER & PHILIP ALSTON, INTERNATIONAL HUMAN RIGHTS IN CONTEXT 1049 (2d ed. 2000).
131. *Id.*
132. *See id.*, *see also* Beth Stephens, *Taking Pride in International Human Rights Litigation*, 2 CHI. J. INT'L L. 485, 485 (2001) (providing the numbers of ATCA cases).
133. *See* Charles Curlett, Introductory Remarks–Alien Tort Claims Act, International Law Weekend Proceedings, ILSA J. INT'L & COMP L. 273, 274 (2000). "Although [ATCA litigation has] generated two billion dollars in damage awards, none has been collected. *Id.*, Shirin Sinnar, Book Note, *Torture as Tort: Comparative Perspectives on the Development of Transnational Human Rights Litigation*, 38 STAN. J. INT'L L. 331, 332 (2002) (noting on the subject of ATCA law suits that while "obtaining redress from perpetrators is often cited as an objective of transnational human rights cases, few claimants actually receive compensation even after favorable judgment").

claims under a range of judicial doctrines prompted by litigation of international matters. Judges have found international comity, forum non conveniens, sovereign immunity and the act of state, color of law (or state action), and political question doctrines relevant to consideration of ATCA claims.[134]

*C. Judge Bork v. The Alien Tort Claims Act*

Despite the documentary and indirect evidence available regarding the original purposes of ATCA, Judge Robert Bork, in a concurrence to the 1984 per curiam *Tel-Oren v. Libyan Arab Republic* decision, contended that Congress in 1789 had been unaware of the changing nature of the law of nations.[135] Therefore, Judge Bork insisted that Congress intended ATCA to concern only acts that were in violation of the law of nations in 1789 [136] Judge Bork's position has not been supported in the courts.[137] In line with the history presented in sub-section A, the modern scholarly and judicial consensus is that the law of nations is changeable, and that Congress understood this in 1789.[138]

Judge Bork also asserted that the statute provided only a grant of jurisdiction, meaning that ATCA claimants would have to find a cause of action elsewhere for any claim that had not been understood to have a cause of action attached in 1789 [139] Dodge rejects this position as "patently antihistorical,"[140] continuing directly:

> The very notion of an express cause of action did not appear until 1848 – nearly sixty years after Congress passed the Alien Tort Clause. In 1789, it was understood that the common law provided the right to sue for a tort in violation of the law of nations, just as it provided the right to sue for any other kind of tort.[141]

In addition, as is nearly explicit in sub-section A, ATCA s original purpose and intent were to grant foreigners the right to sue for tort claims in federal courts,

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134. *See generally* John Haberstroh, *In re World War II Era Japanese Forced Labor Litigation and Obstacles to International Human Rights Claims in U.S. Courts*, 10 ASIAN L.J. 253 (2003) (discussing ATCA in the context of Japanese forced labor litigation); Phillip I. Blumberg, *Asserting Human Rights Against Multinational Corporations under United States Law: Conceptual and Procedural Problems*, 50 AM. J. COMP L. 493 (2002) (discussing claims against multinational corporations under ATCA). However, an examination of these obstacles falls outside of the scope of this paper.

135. *See Tel-Oren*, 726 F.2d 774, 810-16 (D.C. Cir. 1984) (Bork, J., concurring).

136. *Id.* at 816. Dodge describes this position as "demonstrably incorrect. Dodge I, *supra* note 3, at 240-41.

137 *See id.*

138. Dodge refers to this as the prevailing view. Dodge I, *supra* note 3, at 223; *see also Kadic*, 70 F.3d 232, 239.

139. *See Tel-Oren*, 726 F.2d at 801 (Bork, J., concurring). ("[I]t is essential that there be an explicit grant of cause of action before a private plaintiff be allowed to enforce principles of international law in a federal tribunal."). Judge Blackstone stated, in the late 18th Century, that "The principal offences against the law of nations are of three kinds: 1. Violation of safe-conducts; 2. Infringement of the rights of embassadors [sic]; and, 3. Piracy. 4 WILLIAM BLACKSTONE, COMMENTARIES 68, *quoted in* Dodge I, *supra* note 3, at 226.

140. Dodge I, *supra* note 3, at 237.

141. *Id.* at 237-38.

and early use of the statute actuated this understanding.[142] The judicial consensus is that a cause of action is implicit in ATCA. *Doe v Unocal*'s Ninth Circuit has agreed, finding that ATCA provided a cause of action.[143]

In contrast to Bork's apparent understanding of the statute, ATCA is most accurately understood as "merely" allowing an already existing substantive right of action to be exercised in a new venue, the federal courts.[144] For example, *Filartiga* read ATCA "not as granting new rights to aliens, but simply as opening the federal courts for adjudication of the rights already recognized by international law."[145] ATCA, after all, was not a replacement for, but only added to a common law right of action already available in state courts.[146] The state courts today still have concurrent jurisdiction with the federal circuit over tort claims advanced by non-citizens and can also deal with torts in violation of international law [147] This right under international law to make a tort claim in state courts arose in the colonial era, not from state statutes but from the incorporation of the law of nations into state law, through the inclusion of the law of nations in the American colonies' common law.[148]

In sum, Judge Bork's position is weak in scholarship, and the revival of ATCA as an instrument advancing international human rights is solidly compatible with the statute's original purposes and the Founders' understanding of the law of nations. In this light, it would be a shame if an aggressively conservative Supreme Court, if it were to review *Unocal III,* decided to demolish this human rights weapon. The loss might be especially bitter since the entry point for Supreme

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142. *See* Burley, *supra* note 28, at 463. *See generally* Dodge I, *supra* note 3; Anthony D'Amato, *What Does Tel-Oren Tell Lawyers? · Judge Bork Concept of the Law of Nations is Seriously Mistaken*, 79 AM. J. INT'L L. 92 (1985).

143. *See Unocal III*, 2002 WL 31063976 at 8; *Unocal II*, 110 F Supp. 2d at 1303.

144. *Filartiga*, 630 F.2d at 887 *See also Tel-Oren*, 726 F.2d at 780 n.5 (Edwards, J., concurring) (referring to the passage from *Filartiga* cited in the text, Edwards stated, "I construe this phrase to mean that aliens granted substantive rights under international law may assert them under § 1350. This conclusion results in part from the noticeable absence of any discussion in Filartiga on the question whether international law granted a right of action.").

145. *Tel-Oren*, 726 F.2d at 780.

146. District court jurisdiction under the Alien Tort Clause was "concurrent with the courts of the several States, or the circuit courts, as the case may be Judiciary Act, ch. 20, § 9, 1 Stat. 73, 77 (1789) (now § 1350), *cited in* Dodge I, *supra* note 3, at 224 n.100.

147. *See* D'Amato, *supra* note 35, at 65.

148. "[T]he law of nations is adopted in it's [sic] full extent by the common law, and is held to be part of the law of the land. Dodge I, *supra* note 3, at 232 (quoting, 4 WILLIAM BLACKSTONE, COMMENTARY 67); Jay, *supra* note 35, at 824-25 (stating that American revolutionaries considered it a "fundamental article of faith that the colonists were entitled to the protection of the common law In the early years of the American Republic, federal judges, leading political figures, and commentators commonly stated that the law of nations was part of the law of the United States."). Partly in answer to the contention that ATCA establishes only federal jurisdiction and not cause of action, Dodge stated that in early post-revolutionary America:

> [V]iolations of the law of nations were widely recognized as common-law crimes [and torts] were the civil counterparts of crimes The important point is that in 1789 neither crimes nor torts in violation of the law of nations required positive legislation to be actionable; both were cognizable at common law.

Dodge I, *supra* note 3, at 232.

Court involvement may turn out to be an ostensibly mundane but so far intractable task: working out a third-party liability standard to apply to Unocal's misbehavior.

## IV *DOE v. UNOCAL* SOURCES THIRD-PARTY COMPLICITY

### *A. Three Decisions in Search of a Standard*

Generally, the *Doe v Unocal* decisions have dealt with the third-party liability standard by considering it a reverse "state action' or "color of law" issue.[149] Under this view, the liability of Unocal depends on whether its conduct meets some standard for complicity with the state's first-party torts.[150] In an alien tort claim, meeting such a standard triggers tort liability· it also triggers classification of Unocal's "private-party" acts as state action, usually a necessary element of a customary international law violation.[151]

Looked at as a whole, *Doe v. Unocal* is a muddle on how to find and establish the liability (or complicity) standard. For example, as the following brief overview illustrates, each of the three decisions, in its re-analysis of the complicity issue, has incorporated new sources of law. The plaintiffs won an initial victory in *Unocal I*: the 1997 decision relied on § 1983 "color of law" doctrine to develop a complicity standard for Unocal's conduct.[152] *Unocal II* reversed the earlier decision in 2000[153] (in part, incidentally, because there was a heavier legal burden on the plaintiffs[154]). *Unocal II* also employed § 1983 doctrine, but dismissed the action because the private and public defendants did not share a common unlawful goal.[155] Innovatively, the decision enlisted relevant Nuremberg Tribunals decisions to support its third-party liability standard.[156] Two years later, *Unocal III* overruled *Unocal II*.[157] While it agreed with consulting Nuremberg tribunal decisions, it rejected *Unocal II*'s readings of them.[158] *Unocal III*'s innovation was to give standard-setting weight to decisions by two recently formed ad hoc international criminal tribunals, the International Criminal Tribunal for the former Yugoslavia (ICTY) and the International Criminal Tribunal for Rwanda (ICTR).[159]

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149. *Unocal II*, 110 F Supp. 2d at 1305.

150. *Id.*

151. However, there are exceptions to the state action requirement. *See Unocal II*, 110 F Supp. 2d at 1305 (stating "the law of nations has historically been applied to private actors for the crimes of piracy and slave trading, and for certain war crimes."); *Kadic*, 70 F.3d at 239-44 (removing the state actor requirement from genocide and war crimes).

152. *Unocal I*, 963 F Supp. at 890-91.

153. *Unocal II*, 110 F Supp. 2d at 1312.

154. *See* Shaw, *supra* note 30, at 1372 (explaining that the *Unocal I* judge "dealt with the case during Rule 12(b)(6) motion for failure to state a claim, and he allowed the plaintiffs to proceed. Later, however, [the *Unocal II* judge] considered the claim as part of the more stringent standard for summary judgment.").

155. *Unocal II*, 110 F Supp. 2d at 1306-07.

156. *Id.* at 1309-10.

157 *Unocal III*, 2002 U.S. App. LEXIS 19263 at 84.

158. *Id.* at 10.

159. *Id.* at 12-13.

Finally, a February 2003 Ninth Circuit order set aside *Unocal III* for en banc review, and again returned to the third-party liability issue, indicating it would address the disagreement between the *Unocal III* majority and concurring opinions over which standard to use.[160]

As noted, the *Doe v. Unocal* decisions have focused on the state action question, but one with a reversed causation of the usual state action analysis. In this regard, both *Unocal I* and *II* used the joint action test, one of four federal common law tests sanctioned by the Supreme Court for determining whether private action is sufficiently connected with official acts to trigger private liability for action "under color of law."[161] The joint action test asks whether private parties and complicit state officials have acted "in concert" to effect a deprivation of constitutional rights.[162] Courts find state action where there is a "substantial degree of cooperative action" between state and private actors in the deprivation of constitutional rights.[163]

In *Unocal I*, plaintiffs alleged that Unocal and state officials were jointly engaged in forced labor and other human rights violations in furtherance of the pipeline project.[164] The court agreed, and decided the allegations were sufficient to support subject-matter jurisdiction under ATCA.[165] Notably however, during its review of court decisions related to joint action, *Unocal I* commented that "some courts have found that the joint action test requires that the state and private actors 'share a common, unconstitutional goal.'"[166] It was this lack of a shared unconstitutional goal between Unocal and the Myanmar military that would be central to the *Unocal II* reversal of the earlier decision.[167]

The *Unocal I* decision also found the Second Circuit's 1995 *Kadic* decision instructive.[168] *Kadic* innovatively made use of 42 U.S.C. § 1983 "color of law" jurisprudence in order to classify private party human rights violations in the former Yugoslavia as state action. Color of law jurisprudence had first been employed in the civil rights era to challenge, as state action, nominally private deprivations of civil rights.[169] *Kadic* explained that color of law extends the

160. *See* Doe v. Unocal Corp., Nos. 00-56603, 00-57197, 2003 U.S. App. LEXIS 2716 (9th Cir. Feb. 14, 2003) (en banc hearing order).

161. *See* Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374, 377-78 (1995) (identifying the four tests as nexus, state compulsion, public function, and joint action).

162. Gallagher v. Neil Young Freedom Concert, 49 F.3d 1442, 1453 (10th Cir. 1995).

163. *Id.* at 1454.

164. *Unocal I*, 963 F Supp. at 883.

165. *Unocal I*, 963 F Supp. at 891.

166. *Id.* (quoting Cunningham v. Southlake Ctr. for Mental Health, Inc., 924 F.2d 106, 107 (7th Cir. 1991)).

167. *See Unocal II*, 110 F Supp. 2d at 1306-10.

168. *Unocal I*, 963 F Supp at 890.

169. *See* Adickes v. S.H. Kress & Co., 398 U.S. 144, 152 (1970) (finding a basis for relief under § 1983 when a police officer and employee of private firm "reached an understanding" to violate plaintiff's constitutional rights); United States v. Price, 383 U.S. 787 794 n.7 (1966) (stating "In cases under [42 U.S.C.] § 1983, 'under color' of law has consistently been treated as the same thing as the 'state action' required under the Fourteenth Amendment"). *See also* Collins v. Womancare, 878 F.2d 1145, 1148 (9th Cir. 1989) (finding that the Supreme Court had made distinction between the color of

liability associated with state action to any individual who "acts together with state officials or with significant state aid."[170] For such an individual the § 1983 jurisprudence "is a relevant guide to whether a defendant has engaged in official action for purposes of jurisdiction under [ATCA]."[171]

*Unocal I* was cheered as a substantial victory for human rights abuse victims because it recognized a "'knew or should have known' theory against a corporation that 'looked the other way' and benefited from atrocious acts."[172] Human rights advocates' hopes were of course deflated by *Unocal II*.[173] A critical difference from *Unocal I* was *Unocal II*'s more demanding interpretation of the joint action test.[174] In order to classify their acts as state action, the court held that corporations must do more than benefit from state wrongdoing.[175] Specifically, corporations must conspire or participate with the state in the violations of international law and exercise control over the actions of the state.[176] Working from the § 1983 case law, the court stated:

> In order for a private individual to be liable for a § 1983 violation when the state actor commits the challenged conduct, the plaintiff must establish that the private individual was the proximate cause of the violation. In order to establish proximate cause, a plaintiff must prove that the private individuals exercised control over the government official's decision to commit the section 1983 violation.[177]

The Nuremberg Tribunal characterizations of joint action and complicity also underpin the *Unocal II* understanding of the joint action test.[178] According to the court, Nuremberg rested its guilty verdicts in several trials of industrialists who had used Third Reich slave labor "not on the defendants' knowledge and acceptance of benefits of the forced labor, but on their active participation in the unlawful conduct."[179] In fact, the tribunal acquitted defendants who had not

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law and state action concepts).

170. *See Kadic*, 70 F.3d at 245.

171. *Id.*

172. John Christopher Anderson, *Respecting Human Rights: Multinational Corporations Strike Out*, 2 U. PA. J. LAB. & EMP L. 463, 500 (2000).

173. *See, e.g.*, Maria Ellinikos, *American MNCs Continue to Profit from the Use of Forced and Slave Labor Begging the Question: Should America Take Cue from Germany?* 35 COLUM. J.L. & SOC. PROBS. 1, 12 ("As the Unocal case law reveals, all legal efforts to provide relief for the forced laborers in Burma thus far remain fruitless.").

174. *Unocal II*, 110 F Supp. 2d at 1305-06; *Unocal I*, 963 F Supp. at 890 (citing Dennis v. Sparks, 449 U.S. 24, 27 (1980)).

175. *See Unocal II*, 110 F Supp. 2d at 1305-06.

176. *Id.* at 1305-07

177. *Id.* at 1307 (citing *King v. Massarweh*, 782 F.2d 825, 829 (9th Cir. 1986)).

178. *Unocal II*, 110 F Supp. 2d at 1309-10.

179. *Id.* at 1310. *Unocal III* rejected application of this standard:

> The District Court incorrectly borrowed the "active participation" standard for liability from war crimes cases before Nuremberg Military Tribunals involving the role of German industrialists in the Nazi forced labor program during the Second World War. The Military Tribunals applied the "active participation" standard in these cases only to overcome the defendants' "necessity defense. In the present case, Unocal did not

exercised initiative in acquiring forced labor.[180] Examining Unocal's actions, the *Unocal II* court agreed that the evidence suggested that the corporation knew forced labor was being used and that it was benefiting from its use.[181] Guided by Nuremberg, however, the court ruled that such a showing did not establish liability under international law, since Unocal had not actively sought the use of forced labor.[182]

Commentators on *Unocal II* have criticized its use of the joint action test and its "active participation" standard, citing several international tribunal decisions' less stringent tests for classification of private party acts as state action.[183] Notably undemanding was the standard in *Prosecutor v. Tadic*,[184] where the Appeals Chamber of the ICTY dealt, in a prosecution appeal of a trial court judgment,[185] with ascription of responsibility to a state for a private (paramilitary) group's acts on its behalf.[186] *Tadic* found that individual action could be under color of law without substantial state involvement.[187] Specifically, "when a State entrusts a private individual (or group of individuals) with the specific task of performing lawful actions on its behalf, but then the individuals, in discharging that task, breach an international obligation of the State, state action can be found without substantial participation by the state in the non-state actors' international law violations. [188] In such a case, "by analogy with the rules concerning State responsibility for acts of State officials acting ultra vires, *Tadic* asserted that the state becomes responsible for the private individuals' acts with the specific request to act on the state's behalf.[189]

However, what about the reverse? Would private individuals, such as the *Doe*

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invoke – and could not have invoked – the necessity defense.

*Unocal III*, 2002 U.S. App. LEXIS 19263, at 37 The Nuremberg tribunal, the court noted, defined the necessity defense as follows: "Necessity is a defense when it is shown that the act charged was done to avoid an evil both serious and irreparable; that there was no other adequate means of escape; and that the remedy was not disproportionate to the evil. *Id.* at 37 n.21 (quoting *United States v. Krupp*, 9 Trials of War Criminals Before the Nuremberg Military Tribunals Under Control Council Law No. 10, 1436 (1950). The court also stated that a reasonable fact finder might find Unocal liable even if the "active participation" standard were applied. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 38 n.22.

180. *Unocal II*, 110 F Supp. 2d at 1310.

181. *Id.*

182. *Id.*

183. *See* Craig Forcese, *ATCA's Achilles Heel*, 26 YALE J. INT'L L. 487, 508 (2001). *See generally* Brad J. Kieserman, Comment, *Profits and Principles: Promoting Multinational Corporate Responsibility by Amending the Alien Tort Claims Act*, 48 CATH. U. L. REV. 881, 882 (1999) (criticizing the rejection by multinational corporations of responsibility "for the abusive conduct of their foreign host governments.").

184. Prosecutor v. Tadic, Judgment of the Appeals Chamber, No. ICTY-94-1-A (July 15, 1999) [hereinafter *Tadic 1999*]. *Unocal III* applied Prosecutor v. Tadic, No. IT-94-1-T (May 7 1997) (Opinion and Judgment) [hereinafter *Tadic 1997*] and several other ICTY cases in its analysis of Unocal complicity. *See Unocal III*, 2002 U.S. App. LEXIS 19263, at 12.

185. *Tadic 1997 supra* note 184.

186. *Tadic 1999*, *supra* note 184, at ¶ 97

187 Id. at ¶ 119.

188. *Id.*

189 *Id.* Ultra vires refers to actions "beyond the scope of power allowed or granted by law. BLACK'S LAW DICTIONARY 1525 (7th ed. 1999).

*v. Unocal* defendants, become responsible for state acts if they had specifically requested the state to act on their behalf? Only such reversed causation would seem to make the *Tadic* scenario apply to *Doe v. Unocal*. However, the question has in effect already been answered: *Unocal I* had reversed the third and first party roles, finding the complicit private party liable, and under color of law, for the state's first-party acts.[190] In fact, one commentator has suggested ATCA decisions are "evidently very comfortable" using state action doctrine to attach liability for state acts to complicit private parties.[191]

*Unocal III* employed an updated version of the *Tadic* test.[192] Specifically the court made use of another ICTY case, *Prosecutor v. Furundzija*,[193] importing most of its aiding and abetting actus reus standard, which required "practical assistance, encouragement, or moral support which has a substantial effect on the perpetration of the crime."[194] *Unocal III* then returned to the 1997 *Tadic* trial chamber decision to clarify when the accomplice's acts have the required "substantial effect on the perpetration of the crime."[195] The effect is substantial, the court stated, when "the criminal act most probably would not have occurred in the same way [without] someone act[ing] in the role that the [accomplice] in fact assumed."[196]

For the mens rea aiding and abetting standard, *Unocal III* again turned to *Furundzija*, which held the requirement to be constructive (i.e., a reasonable person's) or actual "knowledge that [the accomplice's] actions will assist the perpetrator in the commission of the crime."[197] Further, "it is not necessary for the accomplice to share the mens rea of the perpetrator, in the sense of positive intention to commit the crime."[198] Finally, the aider and abettor is not required to know the precise crime the principal intends to commit.[199] Instead, if the accomplice "is aware that one of a number of crimes will probably be committed, and one of those crimes is in fact committed, he has intended to facilitate the commission of that crime, and is guilty as an aider and abettor."[200] *Unocal III* came close to declaring its "*Furundzija* standard" the current criterion for aiding and abetting liability under international law [201]

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190. *Unocal I*, 963 F Supp. at 891.

191. *See* Forcese, *supra* note 183, at 498.

192. *See Unocal III*, 2002 U.S. App. LEXIS 19263, at 12-16.

193. Prosecutor v. Furundzija, ICTY-95-17/1-T (Dec. 10, 1998), *reprinted in* 38 I.L.M. 317 (1999), *quoted in Unocal III*, 2002 U.S. App. LEXIS 19263, at 12.

194. *Id.* at ¶ 209.

195. *Id.*

196. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 12, (quoting *Tadic 1997 supra* note 184, ¶ 688).

197 *Furundzija*, ICTY-95-17/1-T at ¶ 245, *quoted in Unocal III*, 2002 U.S. App. LEXIS 19263, at 12.

198. *Id.*

199. *Id.*

200. *Id.*

201. The concurrence accused the majority of this. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 30 (Reinhardt, J., concurring). The majority disagreed. *Id.* at 12. The majority writes that, "with respect to practical assistance and encouragement, these [ICTY and ICTR] decisions accurately reflect the current standard for aiding and abetting under international law as it pertains to the ATCA. *Id.* at 12-13 (internal quotations omitted).

*Unocal III* declared that applying the criminal tribunal test in a tort action is not problematic, since the international criminal standard is similar enough to the domestic tort law aiding and abetting standard.[202] It derived the latter from the Restatement (Second) of Torts (1979): "For harm resulting to a third person from the tortious conduct of another, one is subject to liability if he (b) knows that the other's conduct constitutes a breach of duty and gives substantial assistance or encouragement to the other so to conduct himself."[203] Note, however, that the standard adopted by *Unocal III* gives no weight to the last four words of the preceding quotation, "so to conduct himself," if those words mean that a mens rea aiding and abetting element is an intent to encourage or assist the first party's specific breach of duty

In sum, *Unocal III* derived from *Furundzija* both its actus reus aiding and abetting requirement – "practical assistance or encouragement which has a substantial effect on the perpetration of the crime of, in the present case, forced labor"[204] – and its mens rea requirement – "actual or constructive (i.e., reasonable) knowledge that the accomplice's actions will assist the perpetrator in the commission of the crime."[205]

As will be discussed in the following section, the *Unocal III* concurrence disagreed with the majority's third-party aiding and abetting standard because it rejected its sources of law. In brief, the concurrence would reject the standards developed from "evolving standards of international law, such as a nascent criminal law doctrine recently adopted by an ad hoc international criminal tribunal,"[206] and instead would develop a liability rule from federal common law principles.[207] The principles of agency, joint venture, and reckless disregard are well established in the federal common law, the concurrence states, "and disputed questions of fact exist with respect to each."[208] Thus, like the majority, the concurrence found the plaintiffs were entitled to go to trial.[209]

The concurrence is one indication that *Unocal III* has not finally settled the third-party liability issue, especially regarding its sources of law, and the February

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202. *Id.* at 13.

203. RESTATEMENT (SECOND) OF TORTS (1979) § 876, *quoted in Unocal III*, 2002 U.S. App. LEXIS 19263, at 13.

204. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 14. The concurrence criticized the court for being inconsistent because it excluded the *Furundzija* sub-element, "moral support, from its actus reus:

> [B]y substituting international law standards for federal common law, rather than following federal common law and incorporating those portions of international law that attract sufficient legal support, the majority has lost whatever opportunity it had to pick and choose the aspects of international law that it finds appealing. Having declared that international law governs, and that the Yugoslav Tribunal's standard constitutes the controlling international law, the majority cannot then escape the implications of being bound by the law it has selected.

*Id.* at 30 n.9 (Reinhardt, J., concurring).

205. *Id.* at 15.

206. *Id.* at 26.

207 *Id.*

208. *Id.* at 30.

209. *Id.*

2003 Ninth Circuit order for an en banc review is another.[210] That order indicates the en banc panel will closely consider the concurrence and majority liability standard disagreement.[211] Beyond the en banc review, the Supreme Court may await its chance to speak on the issue.

### *B. Unocal III's Choice of Law Confusion*

#### 1 Introduction

The *Doe v. Unocal* judges have experienced conflict of law difficulties, or at least that is one way to explain the several incarnations of the liability standard throughout the litigation. The conflicting analyses of the choice of law issue by the *Unocal III* majority and concurrence may help to illustrate the problem. Both look to the Restatement (Second) of Conflict of Laws,[212] as Ninth Circuit precedent insists.[213] The seven restatement factors are as follows:

> (1) [T]he needs of the interstate and international systems[,] (2) the relevant policies of the forum, (3) the relevant policies of other interested states and the relative interests of those states in the determination of the particular issue; (4) the protection of justified expectations, (5) the basic policies underlying the particular field of law, (6) certainty, predictability and uniformity of result, and (7) ease in the determination and application of the law to be applied.[214]

The majority concluded that the above factors compel it to apply international law generally, and specifically the third-party liability standards derived from the Nuremberg, ICTY and ICTR international criminal tribunals. The majority maintained its choice was favored by factors (1), (4), (5), (6), and (7) above, and found factor (2) at worst neutral.[215] Specifically, regarding factor (1), it stated that the needs of the international system are best served by applying an international standard for aiding and abetting.[216] Regarding factor (2), the majority found the forum has no settled standard to disturb, so the adoption of the international tribunal-based standard will not upset existing forum policy.[217] Factor (5), advancing the underlying policy of the concerned field of law, also favored international law.[218] The underlying policy which the majority determined is "to provide tort remedies for violations of international law, is best served by international law.[219] Finally, regarding factors (4), (6), and (7), the majority stated

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210. Doe v. Unocal Corp., 2003 U.S. App. LEXIS 2716 (9th Cir., Feb. 14, 2003).

211. *See generally* Koh, *supra* note 7 (discussing the June en banc hearing).

212. *Unocal III*, 2002 U.S. App. LEXIS 19263.

213. *See In re* Vortex Fishing Sys., Inc., 277 F.3d 1057, 1069 (9th Cir. 2002) (stating that "[f]ederal choice of law rules follow the approach of the Restatement (Second) of Conflict of Laws.").

214. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6 at 10 (1971).

215. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 11.

216. *Id.*

217 *Id.*

218. *Id.*

219. *Id.*

that the standard it adopted, "from an admittedly recent case, nonetheless reached back at least to the Nuremberg tribunal and was similar to the standard set down in the Restatement (Second) of Torts.[220]

The concurrence decided instead for application of a third-party liability standard grounded in federal common law principles.[221] It stated that factors (2), (4), (5), (6), and (7) favor application of federal common law regarding third-party liability, and found factors (1) and (3) neutral, if not also favoring federal common law.[222] Regarding factor (2), the concurrence stated the forum's relevant policy was creation of a federal forum "where courts may fashion domestic common law remedies" for torts in violation of customary international law.[223] On the protection of justified expectations, factor (4), the concurrence maintained those expectations would be limited, since no Ninth Circuit direct precedent existed for third-party ATCA liability.[224] That said, the federal common law principles of agency joint-venture liability and reckless disregard were well known and regularly applied in many contexts, while the tribunal standard was new and the nature of tribunals made their law unsettled.[225] As for factor (5), the policy underlying the field of law is to provide "an appropriate tort remedy" for customary international law violations and "[t]he application of third-party liability standards generally applicable to tort cases directly furthers the basic policy of using tort law to redress international wrongs."[226] Regarding factor (6), the concurrence predicted that future decisions' "certainty, predictability and uniformity of result" would be enhanced by the wealth of precedent available in federal common law and by independence from "the future decisions of some as-yet unformed international tribunal established to deal with other unique regional conflicts."[227] Finally, the concurrence concluded that the well-developed federal common law is most compatible with factor (7), "ease in the determination and application of the law to be applied."[228] The concurrence found the remaining choice-of-law factors, (1) and (3), "neutral, at the least, and certainly not contrary to the use of federal common law."[229]

2. Against the Concurrence's Federal Common Law Approach

Both the majority and concurrence analyses pointed out the central weakness in the other side's choice of law. The choice of law by the concurrence, for example, appears to reduce an ATCA tort to what the majority termed "a garden-

220. *Id.*
221. *Id.*
222. *Id.*
223. *Id.* at 28 (Reinhardt, J., concurring) (quoting Abebe-Jira v. Negewo, 72 F.3d 844, 848 (11th Cir. 1996)).
224. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 28.
225. *Id.*
226. *Id.*
227. *Id.*
228. *Id.*
229. *Id.*

variety municipal tort."[230] This resulted from treating the statute as "essentially a jurisdictional grant only, and then looking to domestic tort law for the cause of action.[231] In other words, the concurrence, in part, determined whether there was an ATCA cause of action from "the internal law of a nation as opposed to international law."[232] Making such a determination from municipal law disserves the emerging international human rights regime. For example, one scholar has maintained, if judges worldwide are to build "an enduring jurisprudence of international human rights law, it will be because those norms converge from adjudications in multiple jurisdictions each reflecting the socio-political structures of its constitution, while seeking to conform local practices to evolving international standards."[233]

Yet, the concurrence's interpretation is permitted by the wording of ATCA, since that statute does not declare what law should determine matters ancillary to the primary one of finding a tort in violation of international law This paper simply argues that an alternative reading, based on common sense and an equally accurate understanding of the purposes and objectives of the statute, should override the concurrence's interpretation. In this regard, recall first that the statute's general objective was to bring the law of nations under sway of the federal judiciary In addition, note that ATCA refers to a jurisdictional grant alone simply because a grant of a cause of action was assumed, under the widespread late 18th Century understanding that a cause of action was already available through the incorporation of natural law into federal and state common law. Therefore, the law of nations marks out the character of the cause of action. From this perspective, to find Unocal potentially liable with a third-party standard less stringent than that of international law, as I believe the concurrence did, allows ATCA to stray far from its focus, the violation of norms commanding the world's "general assent."[234]

*Abebe-Jira v. Negewo*, an Eleventh Circuit Court of Appeals case quoted earlier in this section, also exposes difficulties in the concurrence's position.[235] In an effort to establish a federal remedy that would "give effect to violations of customary international law,"[236] *Abebe-Jira* states, it would be incongruous to use the same statute to provide remedies for violations of federal common law alone. Rather, at the first opportunity, when the decision on a grant of jurisdiction is made, customary international law and its substantive standards should control regarding the alleged acts of all defendants, including those facing allegations of complicity.

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230. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 11 (quoting Xuncax v. Gramajo, 886 F Supp. 162, 183 (D. Mass. 1995) (internal quotations omitted)).

231. *Id.*

232. BLACK'S LAW DICTIONARY 831 (7th ed. 1999).

233. M.O. Chibundu, *Making Customary International Law through Municipal Adjudication: A Structural Inquiry*, 39 VA. J. INT'L L. 1069, 1148 (1999).

234. *Filartiga*, 630 F.2d at 881 (quoting *Habana*, 175 U.S. at 694).

235. *Abebe-Jira*, 72 F.3d at 848.

236. *Id.*

As indicated earlier, the concurrence argued that federal common law should be drawn from to establish a third-party liability standard, because that matter is "ancillary" rather than substantive.[237] The concurrence correctly understood as substantive the tort itself, and understood as ancillary that which does not create or define the first party's acts.

However, another understanding is that "substantive law" is "the part of the law that creates, defines, and regulates the rights, duties, and the powers of the parties,"[238] not merely the first party From this perspective, the liability standard for the third party is substantive law As even the concurrence agrees, international law should interpret "the substantive component of the ATCA."[239] As a matter of common sense, of course, the liability standard has been far more than subordinate or ancillary· at every step of the litigation it has been singularly critical in determining whether the case is dismissed or goes forward.[240]

In summary, while ATCA explicitly grants federal courts jurisdiction over torts in violation of customary international law, the natural law that already had "granted" the statute's cause of action was concerned only with violations of international law, for example violations by third parties of rights and duties derived from international law. The statute was not meant to allow federal jurisdiction over parties in violation only of municipal law, and courts should bar any wider application of the statute.[241] Therefore, courts should not apply a federal common law standard to third party wrongs.

3. Against the Majority's International Tribunal Approach

The majority was right to reject the use of federal common law for determining a liability rule and properly found the standard in international law. However, the majority erred in *where* it looked for the international standard. The concurrence justly derided the majority's use of a third-party liability rule only recently generated by the ICTY [242]

The standard set down by that tribunal was peculiarly broad, as seen in several paragraphs of the 1997 *Tadic* decision, spelling out the *Unocal III* standard:

> The Trial Chamber finds that aiding and abetting includes all acts of assistance by words or acts that lend encouragement or support, as long as the requisite intent is present. Under this theory, [if] presence can be shown or inferred, by circumstantial or other evidence, to be knowing and to have direct and substantial effect on the commission of

237 *Unocal III*, 2002 U.S. App. LEXIS 19263, at 27 (Reinhardt, J., concurring) (stating that there is no "reason to apply international law to the question of third-party liability simply because international law applies to the substantive violation; as discussed above, federal common law is properly invoked when the statute at issue leaves an ancillary question unanswered ").

238. BLACK'S LAW DICTIONARY 1161, (7th ed. 1999).

239. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 27.

240. In *Unocal I, II* and *III*, the liability issue decided whether the plaintiffs' case would go forward or be dismissed. *See supra* Part IV.A-B.

241. *See infra* Part IV.C.

242. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 24 (Reinhardt, J., concurring).

> the illegal act, then it is sufficient on which to base a finding of participation and assign the criminal culpability that accompanies it. Moreover, when an accused is present and participates in the beating of one person and remains with the group when it moves on to beat another person, his presence would have an encouraging effect, even if he does not physically take part in this second beating, and he should be viewed as participating in this second beating as well. However, actual physical presence when the crime is committed is not necessary[, but] the acts of the accused must be direct and substantial.[243]

This standard was "legally suspect" even for Michael Scharf, a prominent ICTY 'insider' and a *Tadic* judgment supporter.[244] More evidence is needed in the United States to find criminal liability for aiding and abetting.[245] "For a conviction, there must be proof that the defendant either physically assisted the perpetrator in the commission of the crime, stood by with intent (known to the perpetrator) to render aid if needed, or that he commanded, counseled, or otherwise encouraged the perpetrator to commit the crime."[246] Moreover, absent "contributing actual aid, criminal liability cannot lie unless the bystander's approval is manifested by some word or act, such that it affects the mind of the perpetrator."[247] The "encouragement" element of the *Tadic* standard, for example, is reminiscent of the prosecution's proposed standard in what Scharf calls, "the infamous Big Dan's rape trial,"[248] later the subject of a popular movie, The Accused. In that trial, the prosecutor's theory was that cheering bystanders had contributed to the crime of rape. Defendants were acquitted of charges resting on that theory [249]

To develop an encouragement standard, the ICTY has made overly restrictive surveys of judicial decisions to discover applicable international law, concentrating almost exclusively on Nazi-era military tribunal cases.[250] In *Tadic*, for example, Nazi-era war crimes and crimes against humanity decisions are the only cases looked at in its examination of the aiding and abetting issue.[251] Specifically, the decision's "Required extent of participation" section first discusses the Nuremberg

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243. *Tadic 1997*, *supra* note 184, at ¶¶ 689-91.

244. Michael P Scharf, *Trial and Error· An Assessment of the First Judgment of the Yugolavia War Crimes Tribunal*, 30 N.Y.U. J. INT'L L & POL. 167, 200 (1998) ("In short, viewed through American eyes, justice was done in [*Tadic 1997*], though it could have been done better."). Scharf is co-author of a guide to the inner workings of the ICTY cited for guidance in *Tadic 1997* *supra* note 184, at ¶ 536. Virginia Morris and Michael P Scharf, *An Insider Guide to the International Criminal Tribunal for the Former Yugoslavia* (1995) [hereinafter Scharf, *An Insider's Guide*). Scharf has also written an account of *Tadic 1997* MICHAEL P SCHARF BALKAN JUSTICE: THE STORY BEHIND THE FIRST INTERNATIONAL WARCRIMES TRIAL SINCE NUREMBURG (1997).

245. ROLLIN M. PERKINS & RONALD N. BOYCE, CRIMINAL LAW 724 (3d ed. 1982), *cited in* Scharf, *An Insider Guide*, *supra* note 244, at 190.

246. Scharf, *supra* note 244, at 190.

247 *Id.* (citing PERKINS & BOYCE, *supra* note 244, at 742).

248. Scharf, *supra* note 244, at 188. The decision is Commonwealth v. Viera, 519 N.E.2d 1320 (Mass. 1987). The case was later the subject of a well-known movie, The Accused (UIP/Paramount, 1988).

249. *See* Ruth Marcus, *Other Defendants Acquitted; 2 More Convicted in Barroom Rape*, WASH. POST, Mar. 23, 1984, at A1, *cited in* Scharf, *supra* note 244, at 190.

250. *Id.*

251. *Tadic 1997*, *supra* note 184, at ¶¶ 682-87

Tribunal's *Dachau* case, noting that its third element of required proof is that the accused had to have "encouraged, aided and abetted, or participated" in enforcing that notorious Nazi concentration camp's systematic deprivations and cruelties.[252] This is the last time in the sub-section that the court refers to the encouragement notion. In the next paragraph, *Tadic* discusses another Nuremberg concentration camp case, the *Mauthausen* case, which concerned the practice of mass extermination in gas chambers.[253] That court understandably employed a remarkably broad extent of participation standard:

> That any official, governmental, military or civil or any guard or civil employee, in any way in control of or stationed at or engaged in the operation of the Concentration Camp Mauthausen, or any or all of its by-camps in any manner whatsoever, is guilty of a crime against the recognized laws, customs and practices of civilized nations.[254]

The next paragraph of the *Tadic* survey concerns an Auschwitz commander's conviction as an accessory to the murder of 750 individuals, based on his involvement in "procuring Zyklon B gas, constructing gas ovens, arranging for trucks to transport inmates to the gas chambers, and alerting the camp bureaucracy as to the imminent arrival of transports."[255] The following paragraph cites another World War II war crimes tribunal case, in which the British Military Court found the defendants guilty because they "knew that they were going to the woods for the purpose of killing the victims, and therefore the defendants engaged in a common unlawful enterprise.[256] Moreover, the defendant who "stayed in the car to prevent strangers from disturbing the two who were engaged in killing the victims" did not escape culpability.[257] The next case involved the brutalization and killing of downed WWII U.S. pilots by civilians while they were paraded through the streets of a German town.[258] Guards who stood by during the lynching and the official who ordered the parade were among the convicted.[259] Finally, two more World War II cases are cited, these before a French military tribunal. From *Gustav Becker Wilhelm Weber and 18 Others*,[260] *Ferrarese*,[261] and several other cases, the *Tadic* court derives the accused-unfriendly principal that "not only does one not have to be present but the connection between the act contributing to the

252. *Id.* at ¶ 682 (citing 11 UNITED NATIONS WAR CRIMES COMMISSION, LAW REPORTS OF TRIALS OF WAR CRIMINALS, 13 (London, 1949) [hereinafter LAW REPORTS])

253. *Tadic 1997 supra note 184*, at ¶ 683.

254. *Id.* (citing LAW REPORTS, *supra* note 252, at 15).

255. *Tadic 1997 supra note 184*, at ¶ 683 (2 UNITED NATIONS WAR CRIMES COMMISSION, WAR CRIMES REPORTS 48 (London, 1948).

256. *Tadic 1997 supra* note 184, at ¶ 685 (citing Trial of Otto Sandrock and Three Others, British Military Court for the Trial of War Criminals, held at the Court House, Almelo, Holland, on 24-26 Nov., 1945, Vol. I, Law Reports 35, 43 (1947)).

257. *Id.*

258. *Tadic 1997 supra* note 184, at ¶ 687 (citing Case. no. 12-489, *United States v. Kurt Goebell et al.*, Report, Survey of the Trials of War Crimes Held at Dachau, Germany, 2-3 (Sept. 15, 1948)).

259. *Tadic 1997 supra* note 184, at ¶ 687.

260. *Id.* (citing *Gustav Becker, Wilhelm Weber and 18 Others*, Vol. VII, LAW REPORTS 67 70).

261. *Tadic 1997 supra* note 184, at ¶ 687 (citing *Ferrarese*, Vol. VII, LAW REPORTS 67, 81).

commission and the act of commission itself can be geographically and temporally distanced."[262]

In the equivalent *Furundzija* sub-sections[263] (putting aside their references to ICTY and ICTR decisions) only the same or similar trials are examined, all from the Nuremberg tribunals or other courts whose concerns were Nazi-era atrocities.[264] Once again, support is sparse for the notion that encouragement alone can constitute the mens rea of aiding and abetting. Support is found in only two cases: in *Dachau* and in *The Synagogue Case*, decided by the German Supreme Court in occupied Germany [265] The *Synagogue* court held that the status of the accused as a "longtime militant of the Nazi party, along with his general knowledge of the perpetrators' criminal enterprise, were enough to establish the crime's mens rea element, even though the defendant had not planned, ordered, or taken part in the crime against humanity, the destruction of a synagogue.[266]

The exclusive focus on the Nazis and their atrocities is troubling, because it would naturally be expected to generate a mens rea standard of culpability appropriate only for such perpetrators of unmatched evil.[267] As noted above, for example, the Nazi-focused military tribunals was not adverse to establishing catch-all standards that ensured that nearly any German with any coercive authority at the Mauthausen concentration camp would be found guilty of a crime against humanity [268] Recall in this respect how *Furundzija*'s mens rea complicity standard was too broad for the *Unocal III* majority, which refused to incorporate "moral support" into its own standard.[269]

The tribunals for Nazi-era offenses and by the ICTY and ICTR have devised such exceptional standards because of a perceived duty to convict large numbers of individuals culpable in widespread outbreaks of extraordinary evil. [270] Genocide is

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262. *Tadic 1997*, *supra* note 184, at ¶ 687 (citing Vol. VII, LAW REPORTS 67, 70).

263. Prosecutor v. Furundzija, No. IT-95-17/1-T, ¶¶ 199-216, ¶¶ 217-26 (Judgment) (Int'l Crim. Trib. for Former Yugoslavia Trial Chamber Dec. 10, 1998), *reprinted in* 38 I.L.M. 317 (1999) [hereinafter *Furundzija*].

264. *Unocal III* recognized this, although it also described *Furundzija* as undertaking "an exhaustive analysis of international case law" in pursuit of its actus reus aiding and abetting standard: "The international case law it considered consisted chiefly of decisions by American and British military courts and tribunals dealing with Nazi war crimes, as well as German courts in the British and French occupied zones dealing with such crimes in the aftermath of the Second World War. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 36 n.26. It is conceivable, of course, that all third-party liability and aiding-and-abetting international case law has involved Nazi-era criminals.

265. *Furundzija*, *supra* note 263, at ¶¶ 205-09 (citing the case at Strafsenat. Urteil vom 10. August 1948 gegen K. und A. StS 18/48 (Entscheidungen, Vol. I, pp. 53 and 56)).

266. *Furundzija*, *supra* note 263, at ¶ 209.

267 The Nazi regime is "the epitome of absolute evil in Western culture Gerry J. Simpson, *Didactic and Dissident Histories in War Crimes Trials*, 60 ALB. L. REV. 801, 811 (1997).

268. *See Tadic 1997*, *supra* note 184, at ¶ 683 (citing Vol. XI, *Law Reports* 13).

269. *See* note 204 and accompanying text.

270. *See* Scott T. Johnson, *On the Road to Disaster: The Rights of the Accused and the International Criminal Tribunal for the Former Yugoslavia*, 10 INT'L LEGAL PERSP 111, 192 (1998) ("All of [the ICTY's] branches, including the judiciary, are slanted toward fulfilling the Security Council mandate of achieving results: that means convictions not acquittals. As result, the ICTY in its current incarnation cannot fairly adjudicate matters in a neutral and detached way."); *see also* Student

the exemplar of such evil, and the creation of the ad hoc tribunals is commonly understood as an attempt to put a stop to that atrocity [271] An innovative student note in the 2001 Harvard Law Review, in fact, came right out and said what must be on the mind of many a tribunal judge: that the disutility of acquitting a genocidaire is a harm of an order of magnitude greater than the harm of freeing an ordinary murderer.[272] The writer then asked, "If the presumption of innocence really reflects 'a rational world, should not the prosecutor's burden of persuasion drop considerably in cases involving charges of genocide?"[273] The ICTY may be attempting to achieve that goal, in part, through the indirect means of standard-setting.[274]

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Note, *Developments in the Law: Fair Trials and the Role of International Criminal Defense*, 114 HARV. L. REV. 1982, 1995 (2001) [hereinafter Student Note]:

> There is little credible evidence of bias for or against any of the ethnic or national groups prominent at the tribunals as defendants or victims. There is somewhat more evidence of a bias against defendants generally, including as critics have noted, the "prosecutorial zeal" demonstrated by judges in public remarks regarding the need for the tribunals to succeed.

*Id.*. *See also* Larry A. Hammond, *Testimony of Larry A. Hammond Before the House International Relations Committee*, Feb. 28, 2002, *available at* http://www.osbornmaledon.com/press/articles/hammond_testimony_house_of_rep.htm (last visited Mar. 10, 2004) (stating that the ICTY judges and prosecutors are subject to "an always present pressure to gain convictions"). A former justice department attorney, Hammond served on a 1993 ABA task force charged with recommending procedural rules to the ICTY *Id.*

The contrast between ordinary crime and acts of extraordinary evil is considered in Miriam J. Aukerman, *Extraordinary Evil, Ordinary Crime: A Framework for Understanding Transitional Justice*, 15 HARV HUM. RTS. J. 39 (2002). *See also* Michael Scharf & Valerie Epps, *The International Trial of the Century? A "Cross-Fire Exchange on the First Case Before the Yugoslavia War Crimes Tribunal*, 29 CORNELL INT'L L.J. 635, 642 (1996) (comparing the Serb-run concentration camps to the Nazi-run World War II concentration camps).

271. *See, e.g.*, *Symposium: Telford Taylor Panel: Critical Perspectives On The Nuremberg Trial*, 12 N.Y.L. SCH. J. HUM. RTS. 453, 458 (1995). Panelist Ruti Teitel described the ad hoc tribunals' origins as "current attempts in Yugoslavia and in Rwanda to stop genocide. *Id.* Panelist Jonathan Bush noted the "new international tribunals established to try genocide in Rwanda and the former Yugoslavia. *Id.* at 460.

272. Student Note, *supra* note 270, at 1992.

273. *Id.*, *see also* Jacob Katz Cogan, *International Criminal Courts and Fair Trials: Difficulties and Prospects*, 27 YALE J. INT'L L. 111, 114 (2002) (describing that "[t]he extreme character of the crimes alleged before international criminal courts makes the case for accountability stronger than in domestic prosecutions.").

274. For comment on ICTY unfairness to the defense, *see* Matthew M. DeFrank, *ICTY Provisional Release: Current Practice, A Dissenting Voice, And the Case for Rule Change*, 80 TEX. L. REV. 1429, 1457 (2002) ("A growing body of academic literature has criticized the Tribunal for denying its accused procedural protections necessary for fair trials."); Vincent M. Creta, *The Search for Justice in the Former Yugoslavia and Beyond: Analyzing the Rights of the Accused Under the Statue and the Rules of Procedure and Evidence of the International Criminal Tribunal for the Former Yugoslavia*, 20 HOUS. J. INT'L L. 381, 390-417 (1998); Student Note, *supra* note 270, at 1994-96. *See also* Simon Jenkins, *The New Order that Splits the World*, LONDON TIMES, Jan. 31, 2001, *available at* http://www.casi.org.uk/discuss/2001/msg00102.html (last visited Mar. 10, 2004) (describing the tribunal as "absurdly partisan").

Regarding bias during the trial of Milosevic, *see* John Laughland, *If This Man Is a War Criminal, Where Is All the Evidence?* MAIL ON SUNDAY (London) 54, Aug. 25, 2002, *available at* 2002 WL 23304850 (Presiding Judge Richard May "has distinguished himself throughout the trial by his

Ultimately, then, war crime trials and their standards are for "the Hitlers, the Goerings, the Pol Pots, the Milosevics, the Karadzics, and other architects of genocide "[275] Perhaps these trials should not be for "ordinary murderers, as their multitudes of purposes may take precedence over the dispensation of justice for matters of less-than-extraordinary evil.[276] Perhaps this also helps to explain

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belligerence towards Milosevic and in particular for his habit of interrupting Milosevic, even sometimes switching off his microphone, whenever the former Yugoslav leader's cross-examination shows up inconsistencies in a witness's evidence."). It is also useful to look at the transcripts of the ICTY trials. *See, e.g., Prosecutor v. Milosevic*, Case No. IT-02-54, Trial Transcript, ¶¶ 9012-45 (Aug. 28, 2002), *available at* http://www.milosevic-trial.org/trial/2002-08-28.htm (last visited Mar. 10, 2004) (describing presiding Judge Richard May's obstructive and belligerent behavior toward Milosevic, and complete permissiveness toward the witness, BBC reporter). Also note the lack of any response to Milosevic's complaint about delivery of extensively revised witness testimony the night before the next witness's testimony. *Id.* at 9044-45.

275. Davida E Kellogg, *Jus Post Bellum: The Importance of War Crimes Trials*, PARAMETERS, Oct. 1, 2002, at 8799, *available at* 2002 WL 18222363. However, it is incongruous for Kellogg to group Milosevic and Karadzic with Pol Pot and the Nazis; the evidence that those two are guilty of genocide is sparse indeed. Nonetheless, the comment indicates that tribunals are set up in the wake of perceptions of extraordinary evil. Regarding the absence of evidence against Milosevic, *see* Laughland, *infra* note 283. The importance of Holocaust imagery in motivating the creation of the ICTY is discussed in Frederic Mégret, *The Politics of International Criminal Justice, European Journal of International Law*, Feb. 09, 2003, *available at* http://ejil.org/journal/Vol13/No5/br1-03.html. Megret reviews seven books on the Balkan crisis, writing that all agree the decisive turn toward international involvement came in the wake of 1992 media reports and images of Nazi-style concentration camps in Bosnia. Regarding the Bosnia conflict, a senior BBC correspondent writes that "a climate was created in which it was very hard to understand what was really going on, because everything came to be seen through the filter of the Holocaust. JOHN SIMPSON, STRANGE PLACES, QUESTIONABLE PEOPLE 444-45 (1998).

276. For a practical view of the purposes of international criminal tribunals, *see* Antonio Cassese, *Reflections on International Criminal Justice*, 61 MOD. L. REV. 1, 1-6 (1998) (stating the principal aims of tribunal justice are: 1) distinguishing culpable perpetrators from others of the same ethnic or other group, 2) dissipating calls for revenge by showing victims that perpetrators are being punished, 3) fostering reconciliation by ensuring that perpetrators pay for the crimes, and 4) creating a reliable record of past atrocities). Cassese is the former chief judge and President of the ICTY *See* Johnson, *supra* note 270, at n.172.

Simpson, *supra* note 267 at 829, offers a theoretical discussion of war crimes tribunal purposes. One of the functions described is legitimation:

> [T]here is a sense that war crimes trials, in revealing to us what war crimes are, also tell us that other acts are not in this category. In this way, Nuremberg tells us that Nagasaki was not a war crime and that the Soviet invasion of Finland in 1941 was not aggression. Similarly, message of the [Klaus] Barbie trial is that torture in Algeria is not war crime or that Vichy France was not as anti-Semitic as Nazi Germany.

*Id. See also* Joan Phillips, *The Case Against War Crimes Tribunals*, THE NATION, Feb. 1995, *available at* http://www.balkan-archive.org.yu/politics/myth/articles/feb95.Joan_Phillips.html (last visited Mar. 10, 2004) (stating that "[t]he concept of war crimes appears to be an ideological construction of New World order politics, used to legitimize the international pecking order by branding some as criminals and casting others in the role of judges.").

The ICTY tribunal may be functioning in such a manner, in particular after NATO's air war on Yugoslavia appeared to violate laws of war. *See Amnesty International, NATO/Federal Republic of Yugoslavia "Collateral Damage or Unlawful Killings? Violations of the Laws of War by NATO During Operation Allied Force* (2000) *available at* web.amnesty.org/ai.nsf/index/EUR700182000 (last visited Mar. 10, 2004); Andreas Laursen, NATO, *The War Over Kosovo, And the ICTY Investigation*, 17 AM. U. INT'L L. REV. 765 (2002). The legitimation purpose may also have been present in the

why their standards diverge from the practice in U.S. criminal courts, as Michael Scharf has confirmed.[277] Our federal courts, therefore, should draw back from and reconsider applying ICTY and ICTR tribunal standards. Special rules for conditions of absolute evil should not underpin generalized international law.

In addition to the general standard-setting problems of tribunals set up to deal with outbreaks of extraordinary evil, the specific nature and purpose of the ICTY and ICTR also generate legal dangers and difficulties.[278] First, each is ad hoc,[279] formed for a particular purpose whose fulfillment may warrant veering from the course of simple justice. The United Nations Security Council established the ICTY for example, in response to a finding of widespread and severe human rights abuses during the bloody disintegration of the former Yugoslavia.[280] The Security Council directly stated that an intended purpose, in addition to that of dispensing justice, was to contribute to "the restoration and maintenance of peace."[281] Other moral and political purposes may also have entered into the

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genesis of the ICTY to deflect a sense that the West, in particular Germany's early recognition of Slovenia and Croatia, had all but assured the anarchic, bloody break-up of Yugoslavia. *See* Misha Glenny, *Germany Fans the Flames of War* NEW STATESMAN, Dec. 20, 1991, at 14. Further:

> Recognition of Croatia and Slovenia will definitely mean war in Bosnia and probably in Macedonia unless a substantial UN peace-keeping force is put in place before it happens. At the moment, the chances of that happening appear slim The struggle in Bosnia would be unspeakably bloody.

*Id.* At the time he wrote, Glenny was BBC's Central Europe correspondent. *See also* SUSAN L. WOODWARD, BALKAN TRAGEDY: CHAOS AND DISILLUSION AFTER THE COLD WAR 147 (1995) (arguing that the Western powers, by allowing the Yugoslav crisis to be defined along ethnic lines, inadvertently "undermined or ignored the forces that opposed the radical nationalists and indirectly contributed to the fulfillment of the best dreams of the national extremists."). *See generally* Bette Denich, *Unmaking Multi-Ethnicity in Yugoslavia: Metamorphosis Observed*, Anthropology of East Europe Review Autumn, 1993, *available at* http://condor.depaul.edu/~rrotenbe/aeer/aeer11_1/denich.html (last visited Mar. 10, 2004) (noting the long-term growth of inter-ethnic alienation and distrust also helped to cause Yugoslavia's disintegration).

277 Scharf, *supra* note 244, at 178-96.

278. *See Unocal III*, 2002 U.S. App. LEXIS 19263, at 27 (Reinhardt, J., concurring):

> The [ICTY] was formed with the limited mandate of adjudicating allegations of human rights abuses that took place in the Balkans in the last decade. Established by Security Council Resolution 827 in May, 1993, it is a temporary body whose members are elected for four-year terms by the members of the United Nations General Assembly. The [ICTR] is a similarly-constituted body.

*Id.*

279. BLACK'S LAW DICTIONARY 41 (7th ed. 1999).

280. *Tadic 1997 supra* note 184, at ¶ 2. The ICTY was established pursuant to Security Council Resolution 808, adopted February 22, 1993, and Security Council Resolution 827, adopted May 25, 1993. *See* U.N. Doc. S/RES/808(1993); U.N. Doc. S/RES/827 (1993). The finding regarding widespread human rights abuses in Yugoslavia was established by an independent commission, formed pursuant to an earlier UN Security Council resolution.

281. *Tadic 1997 supra* note 184, at ¶ 2. Another authoritative voice, UN Under-Secretary-General for Legal Affairs, Carl August Fleischhauer, stated the ICTY had three main goals: "ending war crimes, bringing the perpetrators to justice and breaking an endless cycle of ethnic violence and retribution. *See* Scharf & Epps, *supra* note 270, at 660. The Ambassador to the United Nations, Madeleine Albright, stated the primary purpose of the tribunal should be to "establish the historical record before the guilty can reinvent the truth. *Id.*

formation of the tribunal,[282] and there are ongoing concerns over its political independence.[283] This politicization is problematic, and should weaken confidence in the impartiality of the "work product" of the ICTY including the legal standards it established for itself. In the tribunals' place, international law in general – "the" international law, so to speak – should draw its norms and standards from permanent, democratically accountable legal regimes, in which the dispensation of justice is the overarching and dominant purpose.[284]

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282. *See* YVES BEIGBEDER, JUDGING WAR CRIMINALS: THE POLITICS OF INTERNATIONAL JUSTICE 171 (1999) (writing that establishment of the ICTY was "substitute for an effective, timely, military intervention [during the Bosnian crisis] by the UN Security Council."); Aleksa Djilas, *The Politicized Tribunal*, IWPR TRIBUNAL UPDATE, July 25, 2001, *available at* http://www.globalpolicy.org/intljustice/tribunals/2001/0725icty.htm (last visited Mar. 10, 2004) (inferring from its indictments and other practices, that the tribunal's purposes include punishing NATO's enemies and rewarding its friends); David Binder, *The Ironic Justice of Kosovo*, MSNBC (US), March 17, 2000, *available at* http://www.geocities.com/cpa_blacktown/20000319 balkamsnus.htm (last visited Mar. 10, 2004) (Binder, a New York Times correspondent for the Balkans since 1963, stated, that "[p]ortraying the Serbs as [the origin of evil in the Balkans] is an unwritten doctrine adopted by the State Department at the beginning of the Yugoslav conflicts and continued today, doctrine endorsed and spread by the mainstream media, human rights groups and even some religious communities.").

283. *See, e.g.*, Jamie Shea, *Press Conference Given by Jamie Shea, NATO Spokesperson, and Major General Walter Jertz*, SHAPE Spokesperson (May 16, 1999), *available at* http:// www.nato.int/kosovo/press/p990516b.htm (last visited Mar. 10, 2004). Shea, in response to question regarding ICTY jurisdiction over NATO actions in Kosovo, stated:

> I think we have to distinguish between the theoretical and the practical. I believe that when [Chief Prosecutor] Justice Arbour starts her investigation [into the events in Kosovo], she will because we will allow her to. It's not Milosevic that has allowed Justice Arbour her visa to go to Kosovo to carry out her investigations. If her court, as we want, is to be allowed access, it will be because of NATO.

*Id.*, John Laughland, *This Is Not Justice*, THE GUARDIAN (UK), February 16, 2002, *available at* http://www.guardian.co.uk/Archive/Article/0,4273,4357313,00.html (last visited Mar. 10, 2004) (stating that by refusing to investigate NATO attacks on Yugoslavia, "the strict circumscription of the circumstances under which war may be waged (ius ad bellum) has now been replaced by an infinitely malleable series of double-standards about how it may be waged (ius in bello): on Jamie Shea's own admission in 1999, these standards are deployed in the service of the Hague's pay-masters, the Nato states."). Similarly, others have noted that:

> Although the Yugoslavia Tribunal is designed to be independent from the Security Council, one cannot ignore the facts that the Security Council selected the Tribunal's prosecutor and proposed a short list of judges from which the General Assembly chose. Indeed, given that the battle for control of Bosnia was in large measure a religious war between Bosnian Muslims and Bosnian Serbs, it is astonishing that four of the eleven judges elected by the General Assembly upon the nomination of the Council come from states with predominantly Muslim populations.

Michael Scharf & Epps, *supra* note 270, at 645; Cogan, *supra* note 273, at 119 ("In model domestic judicial systems, the right to prepare a defense, equality of arms, and judicial independence are all more or less taken for granted. [I]n international criminal courts at present, such an assumption would be unwarranted.").

284. Regarding democratic accountability, *see* Cogan, *supra* note 273, at 114. Cogan lamented the absence in international tribunals "of strong community of 'watchdog' observers for fair trial proceedings. *Id.* He concluded that "the realm of international criminal justice is distinguished from domestic criminal justice not simply because accountability [for crimes of such an extreme nature] and sovereignty [in pursuit of, for example, national security objectives] weigh heavier in this context, but

The third-party liability standard might be where the ICTY is most tempted to be partial. After all, the success or failure of the ad hoc tribunal has from the start been widely seen to involve convicting certain national leaders with "command responsibility" for human rights violations in the former Yugoslavia.[285] Therefore, there has always been present a temptation to create a third-party liability standard that is as helpful as possible to tribunal prosecutors. If the tribunal has given in to that temptation, then its third-party liability standard is exceptionally likely to be unique, and out of line both with "normal" international law and standards of liability in the world's domestic legal systems.

The *Tadic* appeals chamber decision may be an example of an ICTY predisposition regarding third-party liability matters. The trial chamber majority had dismissed certain charges because Serbia had not exercised effective control over the Bosnian Serb forces.[286] In a sharp dissenting opinion, Judge Gabrielle Kirk McDonald argued for a much lower threshold to find an individual a de facto agent of a foreign government.[287] ICTY ally Scharf agreed, urgently pointing out the damage a high threshold might do to the future case against the ICTY's ultimate quarry: "the ruling may effectively lift the responsibility for atrocities committed during most of the three and a half year-long conflict [in Bosnia] from Serbian leader Slobodan Milosevic."[288] The Tadic appeals court reversed that aspect of the trial chamber decision.[289]

In sum, it is deeply troubling, in light of the specialized nature of the ICTY the indications of bias (in particular, for *Doe v. Unocal*, regarding command responsibility matters), and the restricted "case law" upon which the tribunal draws, to find that federal courts are "increasingly turning to the decisions by international criminal tribunals for instructions regarding the standards of international human rights law under our civil ATCA."[290] Moreover, the ICTY third-party liability standard simply is not the "world standard, as common sense would understand that phrase.

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also because of the absence of an effective counterweight to check these interests. *Id.*

285. The frame of mind was evident in the run-up to the Tribunal's creation. Julia Preston, *U.N. Creates Tribunal to Try War Crimes in Yugoslav Warfare*, WASH. POST, at 3, Feb. 23, 1993, *available at* http://www-tech.mit.edu/V113/N8/tribunal.08w.html (last visited Mar. 10, 2004). "Last fall, Secretary of State Lawrence S. Eagleburger singled out a number of top Serb politicians and military figures – including Bosnian Serb leader Radovan Karadzic and his powerful patron in neighboring Serbia, President Slobodan Milosevic – as ultimately responsible for war crimes committed by their underlings. *Id.* The following comment by prominent human rights lawyer on the Slobodan Milosevic trial also indicated ICTY insiders' frame of mind: "the whole point of this trial is to show that those who are primarily responsible, who set the ball rolling, can be reached, and not just the foot soldiers who commit the atrocities and bury the bodies. Geoffrey Robertson, *quoted in CNN Intl., Q&A Late Afternoon: Slobodan Milosevic Takes Offensive* (February 15, 2002), *available at* 2002 WL 5129332. For Robertson's insider credentials, see Marlise Simons, *Milosevic Trial Settles Into Slow But Judicious Routine*, N.Y TIMES, March 3, 2003, at 4 (reporting that Robertson had been selected "to head the new special court for war crimes in Sierra Leone.").

286. *Tadic 1997*, *supra* note 184, at ¶ 605.

287 *Id.* at ¶ 607 (McDonald, J., dissenting).

288. Scharf, *supra* note 244, at 196.

289. *Tadic 1999*, *supra* note 184, ¶¶ 156-62.

290. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 12.

*C. Instead, a Paquete Habana Approach*

The *Unocal III* error is an inability to discover a third-party liability standard which has grown, "by the general assent of nations, into a settled rule of international law."[291] But how should a court go about discovering such rules for matters, such as third-party complicity with a regime's internal human rights violations, which only after Nuremberg became firmly categorized as "traditional" international law?[292] How are U.S. courts to avoid imposing their own "idiosyncratic legal rules" upon other countries, in a pretense of applying international law?[293] On the other hand, federal courts also must resist being compelled to adopt, from "an amorphous entity – i.e., the 'law of nations' – standards of liability applicable in concrete situations."[294] Courts need to find tangible sources of law – and not the ad hoc law formed to deal with extraordinary evil – in order to determine the present-day international law.

In pursuit of the concrete, courts should look to the 1900 Supreme Court case, *The Paquete Habana*.[295] The case, which concerned a matter of traditional international law, a belligerent's seizure of coastal fishing vessels as "prize, demonstrated the modern, positivist method for determining customary international law rules.[296] The court stated that in order to ascertain and administer customary international law:

> [W]here there is no treaty and no controlling executive or legislative act or judicial decision, resort must be had to the customs and usages of civilized nations, and, as evidence of these, to the works of jurists and commentators who by years of labor, research, and experience have made themselves peculiarly well acquainted with the subjects of which they treat. Such works are resorted to by judicial tribunals, not for the speculations of their authors concerning what the law ought to be, but for trustworthy evidence of what the law really is.[297]

The decision presented a lengthy historical review, based on primary sources, of actual state practices.[298] The review started with the early 15th Century and proceeded up to the contemporary practice of the "civilized nations."[299] Next,

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291. *Habana*, 175 U.S. at 694.

292. *See* Louis B. Sohn, *The New International Law: Protection of the Rights of Individuals Rather Than States*, 32 AM. U. L. REV. 1, 9 (1982) (stating that prior to Nuremberg individual citizens (and their rights) were the concern of domestic law alone; "apart from a few anomalous cases [they] were not subjects of rights and duties under international law"); Makau Mutua, *From Nuremberg to the Rwanda Tribunal: Justice or Retribution?* 6 BUFF HUM. RTS. L. REV 77 82 (2000) (noting that Nuremberg provided a foundation for the "international criminalization of internal atrocities, despite its subordination of justice to politics).

293. *See Filartiga*, 630 F.2d at 881.

294. *See Tel-Oren*, 726 F.2d at 781 (Edwards, J., concurring).

295. *See generally Habana*, 175 U.S. 677 (demanding determination of the customary international law standard for the treatment of local fishing vessels by warring parties).

296. *Id.* at 678-79.

297 *Id.* at 700.

298. *Id.* at 686-700.

299. The court understood the "civilized nations" to be the European powers and the United States,

secondary sources were surveyed, allowing the court to peruse the opinions of leading jurists, "witnesses of the sentiments and usages of civilized nations."[300] The goal of the reviews of the primary and secondary sources was to determine whether a legal rule had gathered the "general assent of civilized nations. That requirement "is a stringent one, the *Filartiga* court would later write.[301]

After the Nuremberg expansion of international law to internal matters previously not subjects of international law, internal judicial practice must be given prominence in deciding international standards, where, as will increasingly be the case, it is the most representative state practice available. This would be less an innovation than a change in the valuation of domestic law vis-a-vis the law of international tribunals and courts. As *Habana* indicated, for example, courts have long relied on nation states' domestic laws as one form of evidence for customary international law norms.[302] In fact, the *Habana* case does so itself, citing domestic laws regarding cross-border maritime matters.[303] *Filartiga* provides another example, finding it important that "torture is prohibited, either expressly or implicitly, by the constitutions of over fifty-five nations, including the United States."[304] For *Doe v. Unocal*, therefore, an approach in line with *Habana* might examine the world's domestic legal systems for their treatment of third-party tort liability and its near equivalents.[305]

Support for giving higher priority to the standards of domestic legal systems is also found by looking again at standard materials on the sources of customary international law. Fundamental in determining customary international law, according to the Restatement on Foreign Relations Law, is the "general and consistent practice of states followed by them from a sense of legal obligation."[306] The Statute of the International Court of Justice (ICJ), "generally regarded as a complete statement of the sources of international law, declares them to be the following:[307]

> a. international conventions, whether general or particular, establishing rules expressly recognized by the contesting states;

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along with the recent addition of "the Empire of Japan the last state admitted into the rank of civilized nations. *Id.* at 700. The court also implicitly brought Argentina into the civilized circle through its references to the eminent Argentine jurist Calvo. *Id.* at 703.

300. *Id.* at 701.

301. *Filartiga*, 630 F.2d at 881.

302. *See Habana*, 175 U.S. at 689.

303. *See id.* (referring to French ordinance regarding capture of fishing vessels); *id.* at 691 (citing French legal order releasing English fishermen), and *id.* at 694 (discussing a decision by an English court). *See also* M. Erin Kelly, *Customary International Law in United States Courts*, 32 VILL. L. REV. 1089, 1122 (1987) (stating that "courts may look to the domestic laws of the United States and other states as evidence of a norm").

304. *Filartiga*, 630 F.2d at 889 n.13.

305. The *Unocal III* concurrence took a very brief look at the standards of three "national legal systems" and from this concluded that "[t]he status of joint liability as a general principle of law is supported by the fact that it is fundamental to 'major legal systems.'" *Unocal III*, 2002 U.S. App. LEXIS 19263, at 30 (Reinhardt, J., concurring).

306. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 102(2) (1987).

307 IAN BROWNLIE, PRINCIPLES OF PUBLIC INTERNATIONAL LAW 3 (5th ed. 1998).

b. international custom, as evidence of a general practice accepted as law;

c. the general principles of law recognized by civilized nations; [and]

d. judicial decisions and the teachings of the most highly qualified publicists of the various nations, as subsidiary means for the determination of the rules of law.[308]

While the ICJ provision explicitly places judicial decisions in a subordinate position to the practices and customs of nations, judicial decisions may be given greater weight if they are helpful in determining the state practice.[309] "Case law, ranked as subsidiary in subsection (d), nevertheless may reflect the meaning of an ambiguous treaty provision as evidence of the subsequent practice of states."[310]

Further guidance on whether conduct has attained the status of customary international law is offered in the following description of characteristics that acts "obligatory under or consistent with international law" are required to possess: "(1) 'concordant practice' by a number of states relating to a particular situation; (2) continuation of that practice over 'a considerable period of time'; (3) a conception that the practice is required by or consistent with international law; and (4) general acquiescence in that practice by other states."[311] The first two of these requirements are better met, in a positivist conception of international law, by legal rules and standards that are widely shared among the world's domestic legal systems, rather than by the rules and standards of ad hoc international criminal tribunals.

## V CONCLUSION

ATCA represents, both originally and in the present day, a commitment by the United States to bring aliens' customary international law concerns into the federal courts.[312] Our federal courts should carry forward our country's early vow to be receptive to authentic "law of nations" alien tort claims, which today are often international human rights lawsuits. However, the greatest advocates of ATCA as a vehicle for such human rights claims may actually threaten the statute, when they attempt to use ATCA to attack wrongs, such as the softer shades of third-party complicity, which a world consensus has not decided are in violation of customary international law If courts allow expansion of international law not

308. STATUTE OF THE INTERNATIONAL COURT OF JUSTICE, *supra* note 8, at 1055.

309. RESTATEMENT (THIRD) OF FOREIGN RELATIONS LAW § 102(2) (1987). An example of the appropriate use of subsection (d) source is provided in David L. Nersessian, *The Contours of Genocidal Intent: Troubling Jurisprudence from the International Criminal Tribunals*, 37 TEX. INT'L L.J. 231, 238 (2002) ("Case law, ranked as subsidiary in subsection (d), nevertheless may reflect the meaning of an ambiguous treaty provision as evidence of the subsequent practice of states.").

310. Nersessian, *supra* note 309, at 238.

311. Henry J. Steiner, et al., Transnational Legal Problems, 240 (4th ed. 1994) (citing Working Paper by Manley O. Hudson, [1950] 2 Y.B. Int'l L. Comm'n 26 U.N. Doc. A/CN 4/16 (1950).

312. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 8.

based on consensus, and refuse it the guidance of actual, permanent legal regimes, they are breaking with the positivist legal tradition. In this light, perhaps the *Unocal III* judges were misguided by *U.S. v. Smith*, an 1820 Supreme Court decision which stated that the law of nations "may be ascertained by consulting the works of jurists, writing professedly on public law; or by the general usage and practice of nations; *or by judicial decisions recognizing and enforcing that law*"[313] *Smith* does not give state practice greater weight than the learned writings of academics and other jurists; in fact, the jurists are mentioned first.[314] This is classic natural law advice and should be looked on skeptically by those wary of the "new" customary international law.[315]

*Doe v. Unocal* should avoid the methodology of natural law and instead discover the consensus practice within the world's legal systems regarding domestic aiding and abetting tort violations. Gathering many legal systems' rules together, one would likely find the most stringent third-party liability standards nearly universally create tort liability, while progressively more relaxed complicity rules are less and less the object of consensus. Perhaps the more stringent complicity standard of *Unocal II* would be found near universal in domestic practice among nations, and the modified ICTY standard adopted by *Unocal III* far from universal. In fact, while the ICTY standard is similar to some U.S. domestic common law third-party tort liability standards, it is certainly not the consensus even in the United States, as the *Unocal II* decision makes clear.[316] Thus, while it was and is morally wrong for the Unocal Corporation to knowingly or constructively be a party to an increase in the brutal human rights violations perpetrated by the Burmese military, Unocal's complicity with human rights violations would likely not reach a consensus customary international law standard derived from domestic legal systems' practice. In sum, although a *Paquete Habana* approach might vanquish the *Doe v. Unocal* plaintiffs, ATCA itself would remain alive as a vehicle for attacking violations of customary international human rights law if those wrongs violate the laws and standards of the world's legal

313. *Unocal III*, 2002 U.S. App. LEXIS 19263, at 11 (quoting *Filartiga*, 630 F.2d at 880 and United States v. Smith, 18 U.S. (5 Wheat.) 153, 160-61 (1820)) (emphasis added by the *Unocal III* court).

314. United States v. Smith, 18 U.S. (5 Wheat.) 153, 154.

315. *See supra* note 12. Justice Story wrote in 1822 of the law of nations connection to natural law: "Every doctrine, that may be fairly deduced by correct reasoning from the rights and duties of nations, and the nature of moral obligation, may theoretically be said to exist in the law of nations. United States v. The La Jeune Eugenie, 26 F Cas. 832, 846 (C.C.D. Mass. 1822) (No. 15,551), *overruled on other grounds*, 23 U.S. (10 Wheat.) 66 (1825). *See also* Jay, *supra* note 35, at 822 n.11 (writing that at the end of the Eighteenth Century "a consensus existed that the law of nations rested in large measure on natural law. As Emmerich de Vattel contended, and Americans repeated, 'the law of Nations is originally no other than the law of Nature applied to Nations.'" Jay, *supra* note 35, at 822 n.11 (quoting EMMERICH DE VATTEL, THE LAW OF NATIONS, at lvi (Joseph Chitty ed., 1863) (1758)). Moreover, "[t]he law of nations has its foundation in the principles of natural law, applied to states; and in voluntary institutions, arising from custom or convention. Jay, *supra* note 35, at 822 n.11 (quoting Charge to the Grand Jury for the District of Virginia 16 (May 23, 1791) (A. Davis ed. 1791), *in* 2 THE WORKS OF JAMES WILSON 813 (R. McCloskey ed. 1967)).

316. *See supra* notes 134-52 and accompanying text.

systems.[317]

If *Doe v. Unocal* reaches the Supreme Court, however, conservative Supreme Court justices would likely be more tempted by the "originalist" arguments of Bork and Sweeney than by *Habana*. If the originalist view were to become established law, international human rights actions under ATCA would come to an end.[318] That would not be the case if the court were to take the *Habana* approach, which also contrasts with the originalist approach by being in accord with the statute's literal meaning and original intent. All in all, *Habana* is a more attractive option for the Court.

In any case, the legacy of *Filartiga* is under threat. It is threatened by the originalists, of course, but the circumscribed sense of customary international law of *Filartiga* is also endangered by the new customary international law, a descendant of the visionary remarks by Judge Wilson quoted at the outset of this paper.[319] Therefore, federal judges should resist such self-inflation and return to the grounded positivism of *The Paquete Habana*. Federal judges need to reassure those of us who do not want to take wing and fly with Judge Wilson that we do in fact "live in a more positivist age, and that modern-day courts really do "feel less comfortable 'creating' international law "[320]

317 Not just among those *The Paquete Habana* regarded as "civilized. *Habana*, 175 U.S. at 694.

318. Both Bork and Sweeney would exclude all ATCA-based human rights actions. *See Tel-Oren*, 726 F.2d at 813 (Bork, J., concurring); Sweeney, *supra* notes 98 and 105. *See generally* sub-section III.C and accompanying footnotes.

319. THE WORKS OF JAMES WILSON 282 (R. McCloskey ed., 1967).

320. Dodge I, *supra* note 3, at 253-54 (commenting on Judge Story's quotation in *The La Jeune Eugenie*, 26 F Cas. at 846, *reproduced, supra* note 315).

# CHOICE OF LAW IN UNITED STATES CROSS-BORDER INSOLVENCIES

RICHARD E. COULSON

## I. INTRODUCTION

In a period marked by the development of numerous treaties, conventions, and statutes designed to regulate international business, the field of international bankruptcy remains disturbingly resistant to reform. Most of the major initiatives proposed in past decades have failed completely; others, though adopted, have had only moderate impact. As a result, the bankruptcy of a multinational enterprise typically triggers diverse and uncoordinated legal proceedings in various countries connected to the affairs of that enterprise. For instance, this lack of coordination imposes substantial costs both on the bankruptcy process itself, by multiplying administrative expenses, and on international commerce generally, by preventing lenders from predicting accurately the consequences of debtor insolvency The need for a method of addressing international insolvencies that is fair, predictable, and consistent therefore remains pronounced.

The movement to reform international bankruptcy law has been cast largely as a struggle between two opposing camps: universality and territoriality For the past few decades, universalists who argue that international bankruptcies should be administered by a single forum, have been winning the battle. Universalists argue that the centralized administration of cross-border bankruptcies will provide: (1) equality of treatment for all creditors; (2) maximization of the value of the bankruptcy estate; (3) expeditious and efficient administration of the estate; and (4) predictability of outcome. Universalist principles have shaped the discourse as well as the goals of the bankruptcy reform movement.

In the year 2000, however, the consensus that had long favored universality seemed to be weakening. Territoriality, which favors the simultaneous administration of multiple local bankruptcies, is gaining currency among commentators. On the legislative front, the international bankruptcy provisions of the proposed Bankruptcy Reform Act of 1999[1] while purporting to foster universality, instead reveals only a partial commitment to the universality approach. Finally, recent cases evidence the increasing tendency of courts to abandon the battlefield altogether by handling cross-border bankruptcies in an

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1. For current version, see Bankruptcy Abuse and Consumer Protection Act of 2003, H.R. 975, 108th Cong. (2003).

extra-regulatory fashion.[2]

Many recent large bankruptcies, including Swissair, WorldCom, Enron, and United Airlines, necessarily have multi-jurisdictional problems. But smaller enterprises also operate across international borders. What law to apply is traditionally a conflict of laws problem. Nevertheless, as Professor Buxbaum and others point out,[3] cross-border insolvencies have not generally been analyzed in terms of choice of law methodology

First, we need to identify the terminology used in this area of law Professor Buxbaum mentioned "Universality" and "Territoriality"[4] Although neither describes the exact situation in the United States today, both are active elements in efforts to describe courts' efforts to apply the limited legislative guidance. "Universality maintains that a single forum should administer the bankruptcy of an insolvent corporation. The bankruptcy proceeding would reach all assets of the debtor, wherever located, and would distribute those assets to all creditors, wherever located."[5] Generally, it is assumed that this distribution of assets and determination of claims would be done according to the forum's own laws.

Territoriality, in contrast, is the familiar state law collection technique of grabbing the local assets and distributing them to the local creditors according to its own laws.[6] The United States has a long history of trying to reconcile the needs and interests of local creditors in and to local assets (the race to the court house) and the desire for equitable distribution of an insolvent debtor's assets.[7] Naturally, if the debtor is not insolvent, a local creditor may be inconvenienced and taxed with added costs by participating in a foreign proceeding, in theory, however, that creditor will eventually be paid. It is where the assets are insufficient that equality of distribution and other bankruptcy protective tools are needed—such is the international conflict.

As noted, the United States has seldom been purely one or the other. Indeed, the current regime under Bankruptcy Code section 304 has been characterized as "modified universality"[8] This characterization is accurate but a little odd. It would appear that the United States is truer to Universality than any other nation.

In this piece I do not attempt to set out what choice of law principles should govern cross-border insolvencies in the United States. Rather I attempt to trace federal choice of law rules and show how those rules, such as they are, have had limited use thus far in bankruptcy cases. In Part II I discuss choice of law rules and identify what federal choice of law rules are in various contexts. In Part III I

2. Hannah L. Buxbaum, *Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and Theory*, 36 STAN. J. INT'L L. 23, 23-24 (2000) (footnotes omitted) (hereinafter Buxbaum).

3. *Id.* at 25; *see also* Jay Lawrence Westbrook, *Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum*, 65 AMER. BANKR. L. J. 457, 462 (1991).

4. Buxbaum, supra note 2, at 24-27.

5. Buxbaum, *supra* note 2, at 26.

6. *Id.*

7. *Id.* at 27.

8. *See* 11 U.S.C. § 304. *See also* Buxbaum, *supra* note 2, at 27

discuss the trend, if it can be called a trend, in cases decided prior to the Bankruptcy Reform Act of 1979 ("BRA" herein). Part IV examines the structure of the BRA dealing with cross-border issues and discusses selected cross-border cases decided under the BRA showing the limited application of federal choice of law analysis. In Part V I leave with a brief restatement of the problem facing courts in cross-border insolvency cases rather than a solution, other than to suggest that developed choice of law principles are designed to inform the choice and should not be overlooked in deciding whether to apply United States bankruptcy law.

## II. WHOSE CHOICE OF LAW RULES?

### *A. Choice of Choice of Law Rules*

For some time it has been settled that a federal court sitting in diversity jurisdiction shall apply the choice of law rules of the state in which it sits.[9] *Klaxon* was based on *Erie Railroad Co. v. Tompkins*[10] which relied in part on the Rules of Decision Act.[11] This Act provides that "[t]he laws of the several states shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply "[12] Thus the "laws of the several states" includes the forum state's choice of law rules.[13] Does this apply in Bankruptcy?

The answer is curiously clouded. *Vanston Bondholders Protective Committee v. Green* [14] is a starting point. In *Vanston*, the issue was whether interest on interest should be paid in a Chapter 11 bankruptcy proceeding.[15] If it was payable, the first mortgage bondholders would be paid in full, but subordinate creditors would have a reduced share.[16] The Court said:

> What claims of creditors are valid and subsisting obligations against the bankrupt at the time a petition in bankruptcy is filed, is a question which, in the absence of overruling federal law, is to be determined by reference to state law. Determination [of which state's law applies where, as here, other states have significant contacts] requires the exercise of an informed judgment in the balancing of all the interests of the states with the most significant contacts in order best to accommodate the equities among the parties to the policies of those states.[17]

This quote was *dicta,* because the Court held that regardless of whether interest on

9. Klaxon Co. v. Stentor Elec. Mfg. Co., 313 U.S. 487 (1941).
10. Erie R.R. Co. v. Tompkins, 304 U.S. 64 (1938).
11. 28 U.S.C. § 1652 (2000).
12. 28 U.S.C. §1652 (2000).
13. Erie R.R. Co. v. Tompkins, 304 U.S. 64, 80 (1938).
14. Vanston Bondholders Protective Committee v. Green, 329 U.S. 156 (1946).
15. *Id.* at 158.
16. *Id.*
17. *Id.* at 161-162.

interest was allowable under any or all of the potentially interested states' laws, the issue was determinable by reference to the policy of the Bankruptcy Act;[18] that is, there was "overruling federal law."[19] Nevertheless, this case has been the point of jumping off for much analysis. However, this analysis has not pointed in a clear direct line.

It is to be noted that the *Vanston* Court, albeit in *dicta,* used a phrase to state the essential choice of law relation that has similarly become basic in the *Restatement (Second) Conflict of Law* ("Restatement of Conflicts"); they referred to the "states with the most significant contacts,"[20] whereas the core concept of the Restatement of Conflicts is the "most significant relationship."[21] Because the latter, in some version, appears in most states, and because the federal courts have adopted the Restatement of Conflicts as the basis of federal common law choice of law,[22] it often happens that there is no essential difference in the choice of choice of law· thus, the issue is left unresolved. This result was reached by the Fifth Circuit in *Woods Tucker Leasing Corporation v. Hutcheson-Ingram Development Co.*,[23] where it held that Texas and Mississippi would apply the choice of law provision of the Uniform Commercial Code, as would the federal court, in making its own choice to recognize a contractual choice of law provision.[24]

The Second Circuit reached a finer judgment in *In re Gaston & Snow.*[25] The case was a bankruptcy adversary proceeding on an oral contract between a Chapter 11 law firm and its former clients.[26] At issue was the applicable statute of limitations.[27] The court, after noting the division in the courts of appeals, held that because federal choice of law rules are a creature of federal common law, and that because federal common law was only available where there was a significant federal interest, that where state law was the underlying dispositive law, the bankruptcy courts should apply the choice of law rules of the forum and not federal law.[28]

Reaching a directly contrary view is *In re Vortex Fishing Systems, Inc.*[29] That case also involved a statute of limitations which lay at the basis of a claim on which a creditor predicated its standing as an involuntary bankruptcy petitioner.[30]

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18. *Green*, 329 U.S. at 161.

19. *Id.*

20. *Id.* at 162.

21. RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6, cmt. c. (1971).

22. *See, e.g., In re* Vortex Fishing Sys., Inc., 262 F.3d 985, 994 (9th Cir. 2001).

23. Woods Tucker Leasing Corp. v. Hutchison-Ingram Dev. Co., 642 F.2d 744, 748-49 (5th Cir. 1981).

24. *Id.* at 753-54.

25. *In re* Gaston & Snow, 243 F.3d 599 (2d. Cir. 2001).

26. *Id.* at 601-02.

27. *Id.* at 604.

28. *Id.* at 605-07· *see also* Alfred Hill, *The Erie Doctrine in Bankruptcy*, 66 HARV. L. REV. 1013 (1953) (discussing that because *Erie* was partially based on the Rules of Decision Act, *Erie* also applied in bankruptcy).

29. *Vortex Fishing*, 262 F.3d at 985.

30. *Id.* at 994-95.

The case does not carefully discuss our issue but, following earlier circuit law,[31] held that "[i]n a bankruptcy case, the court must apply federal choice of law rules."[32]

Since most substantive rights in bankruptcy are based on state or non-bankruptcy law, and since those state issues are respected in bankruptcy absent federal bankruptcy statutes or strong, clear policies indicating otherwise,[33] it would seem that where state law prescribes the dispositive rule that *Erie* and the Rules of Decision Act are controlling on the choice of law issue, then the forum's choice of law rules would apply Otherwise, federal common law choice of law rules would apply That is the position this article takes. I now turn to a brief discussion of federal choice of law rules as applied when federal law is the dispositive rule. At the end of the article I will briefly consider the choices made in some international bankruptcy related state law issues.

### *B. Federal Choice of Law Brief History*

The question addressed here is how to select between conflicting foreign and federal bankruptcy law. In theory, the United States has the constitutional authority to extend its legislation to the world. Thus, Bankruptcy Code section 541 expressly provides that the estate created by filing a petition extends to all the described property "wherever located and by whomever held."[34] There are, of course, practical limits to this reach—the effect of American law on property located in another country depends entirely on the willingness of the courts of that country to recognize our claims or judgments.[35]

Partially in recognition of this practical limit, and partially as a matter of conflict of laws policy, early on, the Supreme Court adopted the rule that:

> [A]n act of Congress ought never to be construed to violate the law of nations, if any other possible construction remains, and consequently can never be construed to violate neutral rights, or to affect neutral commerce, further than is warranted by the law of nations as understood in this country.[36]

Chief Justice Marshall's language implicitly admits that the law of nations does not limit the powers of Congress as set out in the U.S. Constitution as a matter of law cognizable before U.S. courts, but rather is a matter of construction in the face of general language.

Justice Joseph Story, a founder of American conflicts law, expressed this same idea with a little more force in *The Apollon*,[37] where he said: "[t]he laws of no nation can justly extend beyond its own territories, except so far as regards its

31. *In re* Lindsay, 59 F.3d 942, 948 (9th Cir. 1995).
32. *Vortex Fishing*, 262 F.3d at 994.
33. *Cf.* Butner v. United States, 440 U.S. 48 (1979).
34. 11 U.S.C. § 541 (2000).
35. *See e.g., In re* Int'l Admin. Serv., Inc., 211 B.R. 80 (Bankr. M.D. Fla. 1997).
36. Alexander Murray v. The Charming Betsy, 6 U.S. 64, 118 (1804).
37 The Apollon, 22 U.S. 362, 370 (1824).

own citizens."[38] Justice Story, in stating such, seemingly suggests that there were real limits on a state's power under international law. The Marshall language has prevailed.

In a case involving a Canadian insolvency, the Court held the American creditors to the Canadian proceedings, saying: "[t]hat the laws of a country have no extraterritorial force is an axiom of international jurisprudence, but things done in one country under the authority of law may be of binding effect in another country."[39]

The *Charming Betsy* case is generally looked at as a beginning since it at least makes clear that courts are to use its guidance not as a limit on power where Congress is clear, but as a rule of construction where Congress uses broad boilerplate terms like "any" or "all."[40]

Perhaps the leading modern case is *Lauritzen v. Larsen*.[41] *Lauritzen* was a federal Jones Act[42] case, the facts of which center around a Danish seaman, who signed on a Danish ship while the ship was in New York, and was later injured in Cuba.[43] He sought to assert his claim under the Jones Act, which facially allows "any seaman who shall suffer personal injury in the course of his employment at his election, [to] maintain an action for damages ..."[44] While the Court noted the reach of the actual language, it said: "[b]y usage as old as the Nation, such statutes have been construed to apply only to areas and transactions in which American law would be considered operative under prevalent doctrines of international law."[45] But this holding does not bind U.S. law:

> On the contrary, we are simply dealing with a problem of statutory construction rather commonplace in a federal system by which courts often have to decide whether 'any' or 'every' reaches to the limits of the enacting authority's usual scope or is to be applied to foreign events or transactions.[46]

The Court concluded that Congress could not have intended to apply the Jones Act remedies to a foreign sailor aboard a foreign ship, injured in a foreign port.[47]

Some question about the presumption against extraterritoriality as a basis of statutory construction was raised in the close 5-4 decision in *Hartford Fire Insurance Co. v. California*.[48] In that case, the Court, with two separate 5-4 majorities, applied the Sherman Act[49] to activities by English reinsurers in

38. *Id.*
39. Canadian Southern Ry. Co. v. Gebhard, 109 U.S. 527, 536 (1883).
40. *Id.*
41. Lauritzen v. Larsen, 345 U.S. 571 (1953).
42. 46 U.S.C. § 688 (2000).
43. *Lauritzen*, 345 U.S. at 573.
44. *Id.* at 573 n. 1.
45. *Id.* at 577.
46. *Id.* at 577-79.
47. *Id.* at 592-93.
48. Hartford Fire Ins. Co. v. California, 509 U.S. 764 (1993).
49. 15 U.S.C. § 1 (2000).

England.[50] The majority on our issue simply held that since compliance with U.S. law did not require the London reinsurers to violate English law, that is, compliance would be legal in England, so there was no conflict of laws and U.S. law could be applied.[51] Justice Scalia, who wrote the dissent on this issue,[52] used the analysis followed here. The case does not really suggest there is any qualification of this analysis, but the majority essentially ignored the real conflicts issue presented: whether English law can be construed not to merely permit the conduct prescribed by U.S. law, but to encourage the freedom of its insurance companies to make such choices, at least while in England. This situation classically calls for a conflicts analysis; Scalia does not offer a real conflict analysis, but arguably his discussion is far superior to the simplistic analysis of the majority.

Scalia, following the rules of statutory construction mentioned above, argued that: (1) unless Congress indicates otherwise, federal legislation is only meant to apply within the U.S. and (2) federal statutes should be construed, again where possible, not to violate international law.[53] As a guide to these two canons of construction, he mentioned that many lower courts in Antitrust cases had relied on the doctrine of comity of nations and the rules outlined in the *Restatement (Third) Foreign Relations Law of the United States* ("Restatement of Foreign Relations").[54]

Comity is an older concept still viable in conflicts analysis, especially in international cases. The classic statement associated with the concept of comity is from *Hilton v. Guyot*,[55] where the Court, in considering the enforceability of a French judgment in federal courts, said:

> 'Comity, is neither a matter of absolute obligation, on the one hand, nor of mere courtesy and good will, upon the other. But it is the recognition which one nation allows within its territory to the legislative, executive, or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its own citizens, or of other persons who are under the protection of its laws.[56]

Obviously, the concept of comity is not a test or standard, but a guiding principle of international cooperation. Moreover, it does not expressly, or to my mind implicitly, give any guidance to a choice of law analysis. It addresses a style of thinking which guides a court's attitude when offered the possibility that foreign law should, by some choice of law principles, be applied. As vague as comity is, it has continued to guide much of the thinking about foreign law in U.S. courts,

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50. *Hartford Fire Ins. Co.*, 509 U.S. at 798-99.

51. *Id.* at 800.

52. *Id.* (Scalia also wrote for the majority on different issue).

53. *Id.* at 814-15.

54. *See* Suzanne Harrison, *The Extraterritoriality of the Bankruptcy Code: Will the Borders Contain the Code?* 12 BANKR. DEV. J. 809 (1996).

55. Hilton v. Guyot, 159 U.S. 113, 122-23 (1895).

56. *Id.*

including in bankruptcy proceedings, and plays a prominent role in determining whether to grant relief in an ancillary proceeding.[57]

Courts have found further guidance for the exercise of comity in the provisions of the Restatement of Foreign Relations sections 402 and 403.[58] Foreign relations law in the Restatement includes "international law as it applies to the United States."[59] As we have seen, this international law is not binding in the sense that it overrides applicable federal statutes but serves as a canon of prudent construction. Under section 402, a state has the jurisdiction to apply its law if it chooses to do so, against:

> (1) (a)conduct that, wholly or in substantial part, takes place within its territory;
>
> (b) the status of persons, or interests in things, present within its territory;
>
> (c) conduct outside its territory that has or is intended
>
> to have substantial effect within its territory; [and]
>
> (2) the activities, interests, status, or relations of its nationals outside as well as within its territory.[60]

But even where jurisdiction to prescribe is permitted under section 402, "a state may not exercise jurisdiction to prescribe law with respect to a person or activity having connections with another state when the exercise of such jurisdiction is unreasonable."[61] Section 403(2) offers a nonexclusive list of relevant factors to be applied where appropriate. These factors are:

> (a) the link of the activity to the territory of the regulating state, *i.e.* the extent to which the activity takes place within the territory, or has substantial, direct, and foreseeable effect upon or in the territory;
>
> (b) the connections, such as nationality, residence, or economic activity, between the regulating state and the person principally responsible for the activity to be regulated, or between that state and those whom the regulation is designed to protect;
>
> (c) the character of the activity to be regulated, the importance of regulation to the regulating state, the extent to which other states regulate such activities, and the degree to which the desirability of such regulation is generally accepted;

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57 11 U.S.C. § 304(c)(5).
58. RESTATMENT (THIRD) FOR. REL. §§ 402, 403 (1987).
59 RESTATEMENT (THIRD) FOR. REL. § 1(a). (1987).
60. *Id.* at § 403.
61. *Id.* at §403(1) (1987).

(d) the existence of justified expectations that might be protected or hurt by the regulation;

(e) the importance of the regulation to the international political, legal, or economic system;

(f) the extent to which the regulation is consistent with the traditions of the international system;

(g) the extent to which another state may have an interest in regulating the activity; and

(h) the likelihood of conflict with regulation by another state.[62]

As a non-exclusive list of factors, this list is necessarily consistent with the alternative approach of many courts, which simply state that "[t]he federal common law choice-of-law rule is to apply the law of the jurisdiction having the greatest interest in the litigation."[63] Notice that the Restatement of Foreign Relations factors do not directly focus on choice of law, but rather determine the reasonableness of the extension of federal law to a transaction or person having foreign connections. If the U.S. prescriptive jurisdiction would be unreasonable, federal law should not be applied, but a court need not chose the application of the other state's law; indeed, this determination of unreasonableness logically results in dismissal of the action.

Thus, while the Restatement factors are often treated as principles for implementing comity, they actually focus on different questions. Comity (whatever it means) focuses on whether to apply or defer to the foreign law, while the Restatement delineates when American federal law should be limited or not applied. Neither actually focuses on how to make the decision. This role is also played, albeit vaguely by the greatest interest, or closest connection, or most significant contact standard. But the courts have not developed this degree of coherence, for the most part, in international insolvency A little history might help.

62. RESTATMENT (THIRD) FOR. REL. § 403(2) (1987).

63. *In re* Koreag, Controlle et Revision S.A., 961 F.2d 341, 350 (2d Cir. 1992) (not choosing between federal common law choice of law and the forum (N.Y.) choice of law since they were essentially the same); *In re* Maxwell Communication Corp., 170 B.R. 800, 816 (Bankr. S.D.N.Y 1994), *aff'd* 186 B.R. 807 (S.D.N.Y 1995) and 93 F.3d 1036 (2d Cir. 1996) (on these important cases see below).

## III. PRE-1979 INTERNATIONAL INSOLVENCY CASES[64]

Charles Booth describes a movement in international insolvency law in the United States that shifts from territoriality to universality, back to territoriality, and again to universality, prior to the Bankruptcy Reform Act of 1978.[65] The early cases basically ignore all conflict of laws analysis, and concentrate on the question of the status of claims under a foreign insolvency proceeding.[66] This status inquiry includes recognition of a foreign representative of an estate (more modern cases)[67] and whether the claims of a foreign assignee in a bankruptcy commission can be recognized.

The earliest federal case was *Harrison v. Sterry*.[68] This case involved a British partnership which also did business under a firm name in South Carolina.[69] The contesting parties were the United States; attaching American and British creditors; an assignee for the benefit of creditors, assignees in bankruptcy under a British commission; and an American commission.[70] The issue was the equitable division of property.[71] The Court merely set a scheme for distribution. In so doing, Chief Justice Marshall stated:

> As the bankrupt law of a foreign country is incapable of operating a legal transfer of property in the United States, the remaining two thirds of the fund are liable to the attaching creditors, according to the legal preference obtained by their attachments [thus subordinating the claims of the British bankruptcy assignees].[72]

But having adopted this clear territorialist view, the Court went on to state that any surplus left after the United States and the attaching creditors were paid "ought to be divided equally among all the creditors, so as to place them on an equal footing with each other."[73] In doing so, the British and American bankruptcy distributions should be taken into consideration.[74] While not a pure universality approach, the notion of equality of creditors is part of the rationale for universality

Perhaps a clearer case of subordination of foreign creditors, versus refusal to

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64. This brief section is largely based on Charles D. Booth, *A History of the Transnational Aspects of United States Bankruptcy Law Prior to the Bankruptcy Reform Act of 1978*, B. U. INT'L L. J. 1 (1991).

65. The Bankruptcy Reform Act of 1978 is codified in sections of 11 U.S.C.

66. See text and cases in Part IV B below.

67 This issue is directly addressed as to ancillary proceedings in § 304 of the Bankruptcy Reform Act of 1978. See below.

68. Harrison v. Sterry, 9 U.S. 289 (1809).

69. *Id.* at 291-92.

70. *Id.*

71. *Id.* at 290.

72. *Harrison*, 9 U.S. at 302.

73. *Id.*

74. *Id.*

recognize, is *In re Accounting of Waite*.[75] In *Waite*, the court recognized the claim of a British trustee to property located in New York where no prejudice would be done to local creditors by the transfer of the assets to England for administration.[76] Judge Lowell recognized the developments as not involving conflict of laws analysis:

> We have no law of the *situs* giving preference to our creditors, but simply refuse to interfere and aid the foreign trustee against the legal diligence of our creditors who may have the good fortune to be able to attach or take in execution the effects here before the trustee has removed them.[77]

Thus, the notion of comity raised its head. It was not a choice of law problem—which law should be applied—but a simple policy, which I have referred to as subordination of the claims of the foreign trustee or estate representative, to the claims of local U.S. creditors to assets located in the United States (a version of territoriality).

A big step in the direction of the universality principle, which argues there should be a single proceeding with equal treatment of the same class of creditors, was taken in *Canada Southern Railway Co. v. Gebhard*.[78] In *Gebhard*, secured bondholders of a Canadian railway company were subject to a Canadian scheme of arrangement whereby the old bonds were to be exchanged for new bonds with a longer maturity and lower interest rate.[79] The scheme was approved by three-quarters of the bondholders and the Canadian Parliament.[80] Two dissenting New York bondholders brought suit on their old bonds in the federal circuit court, which held that the bondholders could recover on the old bonds.[81] The Supreme Court reversed.[82] It reached several issues, but for our purposes it should be quoted for its extensive endorsement of the essence of universality·

> Unless all parties in interest, wherever they reside, can be bound by the arrangement which it is sought to have legalized, the scheme may fail. All home creditors can be bound. What is needed is to bind those who are abroad. Under these circumstances the true spirit of international comity requires that schemes of this character, legalized at home, should be recognized in other countries.[83]

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75. *In re* Accounting of Waite, 99 N.Y 433 (1885). The reader is reminded that during the Nineteenth Century we had federal bankruptcy system for only about 17 years. Richard E. Coulson, *Consumer Abuse of Bankruptcy: An Evolving Philosophy of Debtor Qualification for Bankruptcy Discharge*, 62 Alb. L. Rev. 467, 471-477 (1998). During this period, most bankruptcies were state based where inter-state bankruptcy issues were considered international, except where the federal Full Faith and Credit Clause applied. Cf. John Lowell, *Conflict of Laws as Applied to Assignments for Creditors*, 1 Harv. L. Rev. 259 260 (1888)).

76. *In re* Accounting of Waite, 99 N.Y 433,499-50 (1885).

77 Lowell, *supra* note 75, at 261.

78. Canada S. Ry. Co. v. Gebhard, 109 U.S. 527 (1883).

79. *Id.* at 528-29.

80. *Id.* at 530.

81. *Id.* at 531.

82. *Id.* at 540.

83. *Id.* at 539.

Implicitly this statement approved the application of Canadian law. Thus, like many such cases involving the tension between territoriality and universality, the choice of law is made by selecting a jurisdiction through the favorable application of international comity Of course, international comity towards the law of a similar common law nation is the easiest case. I will present that the similarity of legal regimes has become a factor under Bankruptcy Code section 304.

The next case in this selective history is *Hilton v. Guyot,*[84] which has already been mentioned in connection with its classic statement of comity.[85] In *Hilton,* the Court faced the question of the enforceability of a French judgment, by a French liquidator, against two U.S. citizens on debts they owed to the liquidating firm.[86] In addition to the statement of comity quoted above, the Court regressed to the doctrine of territoriality when it said:

> No law has any effect, of its own force, beyond the limits of the sovereignty from which its authority is derived. The extent to which the law of one nation, as put in force within its territory by judicial decree, shall by allowed to operate within the dominion of another nation, depends upon what our greatest jurists have been content to call "the comity of nations."[87]

Using their understanding of the comity of nations, the Court adopted a rule of reciprocity, where the French judgment would not be enforceable in the United States because a U.S. judgment would not be enforceable in France.[88]

Skipping ahead to just before the Bankruptcy Reform Act of 1978[89] the period described above and the intervening period were well characterized by Booth when he wrote that "courts throughout the United States responded inconsistently over the years to issues involving the recognition of foreign insolvency proceedings and the claims of foreign representatives."[90] I would add that they paid little attention to developing any coherent choice of law framework for the solution in foreign insolvency matters. In the 1970s, there were a number of big international cases which presaged many of the looming globalized insolvencies, which we have and yet may see.

I will briefly mention two of these cases, only to illustrate the inadequacy of the then existing Bankruptcy Act. The first of these cases was the insolvency of

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84. Hilton v. Guyot, 159 U.S. 113 (1895).

85. *See supra* notes 55-59, and accompanying text.

86. *Hilton*, 159 U.S. at 114-21.

87. *Id.* at 163.

88. Most states do not require reciprocity concerning foreign judgments, and some authorities think that federal courts must follow state law on this issue where the basis of jurisdiction is diversity including alienage. *See* Eugene F Scoles, et. al, *Conflict of Laws* at 1187ff (3d Ed. 2000). The Restatement of Conflicts also does not require reciprocity. RESTATEMENT (SECOND) CONFLICT OF LAWS § 98 and cmt. e. Many states accord foreign money judgments the essence of full faith and credit via the Uniform Foreign Money-Judgments Recognition Act. *Id.* at cmt. e, and 13 Uniform Laws Anno. Pt. II p. 43 ff.

89. The Bankruptcy Reform Act of 1978 is codified in sections of 11 U.S.C.

90. Booth, *supra* note 64, at 27.

Bankhaus I.D. Herstatt K.G. a. A. ("Herstatt").[91] Its story is fascinatingly told in an American Bar Association article by Joseph D. Becker.[92] It is a tale of weaknesses and doubts that fortunately led to a settlement (as confusion often does) and avoided difficult decisions. Herstatt was a large West German private bank.[93] It had incurred large currency exchange losses as a result of the inflation generated by the 1973 oil embargo.[94] On June 26, 1974, the West German authorities ordered the closing and liquidation of the bank.[95] Herstatt did not conduct any banking business in the United States, but held accounts for clearing purposes in Chase Manhattan Bank, N.A.[96] Chase froze the Herstatt account which had about $150 million, even though Chase's claims were only about $5 million.[97] Attachments against the Herstatt account with Chase began, and by mid-August, aggregated about $200 million from American and foreign banks.[98] Chase filed a federal interpleader action interpleading the Herstatt account.[99] Citibank, a nonattaching creditor, then filed, on August 6, an involuntary bankruptcy petition designed to wipe out the attachments as preferences.[100] Numerous legal issues were then raised, including whether a foreign bank, which did not do banking business in the United States, was excluded from coverage as an eligible debtor by the Bankruptcy Act.[101] In such a case, the attachments could not be voidable preferences on the assumption that U.S. preference law would apply, or whether it was an eligible debtor, in which case the attachments were likely voidable.[102] On November 4, 1974, a bankruptcy judge heard this issue and others.[103] As Booth puts it, "[g]iven the novelty and complexity of this issue, the inadequacy of the legal rules, as well as the almost certain likelihood of appeal, the parties attempted to settle the matter instead."[104] Settlement was shortly accomplished and the bankruptcy case was dismissed.[105]

During the same period, an English bank called the Israel-British Bank (London) Ltd. ("IBB"), had substantially identical problems.[106] On August 2, 1974, it voluntarily commenced winding-up proceedings according to English law.[107] It had bank accounts in U.S. banks, and attachments were levied against these

91. *See* Joesph D. Becker, *International Insolvency: The Case of Herstatt*, 62 A.B.A. J. 1290 (1976).
92. *Id.*
93. *Id.* at 1291.
94. *Id.*
95. *Id.*
96. *Id.*.
97. *Id.*
98. *Id.* at 1292.
99. *Id.*
100. *Id.* at 1292-93.
101. *Id.*.
102. *See id.* at 1291-93.
103. *Id.* at 1293
104. Booth, *supra* note 64, at 29.
105. Becker, *supra* note 91, at 1293-94.
106. *Id.*
107 Israel-British Bank (London), Ltd. v. Fed. Deposit Ins. Corp., 536 F.2d 509, 511 (2d Cir. 1976); *see also* Becker, *supra* note 91, at 1293.

accounts.[108] Attempting to avoid these attachments, IBB voluntarily filed a bankruptcy petition on September 23, 1974.[109] Addressing the issue as to whether a foreign bank not doing banking business in the United States was an eligible debtor under the Bankruptcy Act,[110] the bankruptcy court refused to dismiss, and was reversed by the district court; the district court was in turn reversed by the Second Circuit.[111] While the Second Circuit decided the question about a foreign bank being an eligible debtor,[112] it did not need to use any choice of law analysis because the case simply concerned a federal bankruptcy issue.

This broad survey of the pre-1979 state of the law leaves one in agreement with Judge Lowell who wrote in 1888:

> [I]n the present state of commerce and of communication, it would be better in nine cases out of ten that all settlements of insolvent debtors with their creditors should be made in a single proceeding, and generally at a single place; better for the creditors, who would thus share alike, and better for the debtor, because all his creditors would be equally bound by his discharge.[113]

Judge Lowell's statement does not reflect the even greater complexity of business that exists today as compared to 1888, nor does it recognize the growing need for reasonable, predictable rules of jurisdiction, recognition of foreign proceedings, and choice of what law to apply to what issues. I will now briefly outline the structural setting of the Bankruptcy Reform Act of 1978 and some of its limited choice of law implications, by looking at a few illustrative cases.

## IV THE BANKRUPTCY REFORM ACT OF 1978[114]

### *A. The Structure of Bankruptcy Code Section 304*

The Bankruptcy Reform Act of 1978 ("BRA 1978") as amended, constitutes the present Bankruptcy Code.[115] In light of the history briefly mentioned above, and other factors raised in the legislative history, the BRA 1978 made an approach to what has come to be called "modified universality This concept means that while the law leans towards the concept of a single plenary proceeding where all creditors from all nations are treated somewhat equally (after all no system truly treats all creditors equally—secured creditors, unsecured priority creditors, and general unsecured creditors are not treated alike), the U.S. bankruptcy courts are cautioned by the law to be careful in the recognition of foreign proceedings and to

108. Becker, *supra* note 91, at 1293.
109. *Israel-British Bank*, 536 F.2d at 511.
110. *Id.* at 511-12.
111. *Id.*
112. *Id.* at 513.
113. Lowell, *supra* note 75, at 264.
114. The Bankruptcy Reform Act of 1978 is codified in sections of 11 U.S.C.
115. The present Code is codified in sections of 11 U.S.C.

give some protection to U.S. creditors.[116]

Under the BRA 1978, as Arnold M. Quittner has noted,[117] a foreign debtor has essentially four options for pursuing assets located in the United States.[118] First, it may voluntarily begin a chapter 7 or chapter 11 proceeding, provided it is an eligible debtor under Bankruptcy Code section 109(a), which usually requires that the debtor has a place of business or property in the U.S.[119] Second, if the foreign debtor is in a foreign insolvency proceeding outside the United States,[120] its foreign representative[121] may file an involuntary proceeding under Bankruptcy Code section 303(b)(4).[122] Third, the foreign representative may also file an ancillary proceeding subject to the conditions stated in Bankruptcy Code section 304.[123] Finally under general standards of international comity, the foreign representative or the foreign debtor may seek the assistance of U.S. state or federal courts to claim its property and transfer it to another country [124] Indeed, in the absence of creditors pursuing such property locally, the debtor could just see to the transfer, while a foreign representative would seem to need judicial assistance. Judicial assistance is likely to be expensive if the foreign debtor has property located in more than one U.S. jurisdiction.[125]

This section briefly outlines the variety of U.S. proceedings where foreign claims concerning an international debtor's estate can face a U.S. court. I am going to deal primarily with situations where there are either: (1) two plenary bankruptcy proceedings pending, one abroad and one in the U.S., or (2) a plenary bankruptcy proceeding pending abroad and an ancillary proceeding pending in the U.S. Analytically there is no choice of law difference, except to the extent that the Bankruptcy Code section 304 factors implicate choice of law considerations.

Bankruptcy Code section 304 applies to ancillary proceedings,[126] but its factors have been applied more generally where two plenary proceedings are

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116. *Id.*

117 Arnold M. Quittner, *Introduction to and Overview of Cross-Border Insolvency Issues*, p.2 (2003) (unpublished article on file with the author and the editors).

118. *Id.*

119. *Id.*

120. A "foreign proceeding" is defined as a "proceeding, whether judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor's domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a reorganization. 11 U.S.C. § 101(23) (2000).

121. A "foreign representative" is defined as a "duly selected trustee, administrator, or other representative of an estate in foreign proceeding. *Id.* at § 101(24).

122. 11 U.S.C. § 303(b)(4) (2000).

123. 11 U.S.C. § 304 (2000)

124. Quittner *supra* note 117, at 29 ff.

125. In addition to Quittner *id.*, *see also* Lynn P Harrison, III, *Ancillary Proceedings Under the United States Bankruptcy Code: A Primer in* 2 23rd Annual Current Developments in Bankruptcy and Reorganization p. 175, 185 (P.L.I. 2001). *Cf.* Philadelphia Gear Corp. v. Philadelphia Gear de Mexico, S.A., 44 F.3d 187 (3d Cir. 1994) (where Court of Appeals ordered the District Court to consider whether international comity called for deference to Mexican suspension proceedings).

126. 11 U.S.C. § 304(b) (2000).

pending. For my purposes, section 304 is interesting for its choice of law implications; it is about the only legislative guidance available showing where Congress has chosen to articulate factors involved in a choice of whether to grant relief. Thus, I will first outline the structure and factors of choice in section 304.

A "case ancillary to a foreign proceeding" is begun by a foreign representative filing a petition.[127] Subsection (b) specifically authorizes the bankruptcy court to enjoin "any action against (i) a debtor *with respect to property involved in such foreign proceeding* or (ii) *such property;* or (B) the enforcement of any judgment against the debtor *with respect to such property,* or any act, or the commencement or continuation of any judicial proceeding to create or enforce a lien against *the property of such estate.*"[128] The territorial nature of this assistance is clear, as it authorizes a stay against actions concerning "the property involved in such foreign proceeding[s]" "such property, or "the property of such estate."[129] The subsection goes on to authorize an order requiring the turnover "of the property of such estate, or the proceeds of such property" to the foreign representative.[130] Notice that the property is treated as property of an estate, but this estate cannot be an estate created by federal bankruptcy law because that estate under Bankruptcy Code section 541 (a) is only created by filing a petition under sections 301, 302, or 303, not 304.[131] Also note that in an ancillary case, there is no automatic stay· instead, it is only triggered by a petition under the same three sections.[132] The subsection finally authorizes the court to "order other appropriate relief."[133] This provision clearly provides far reaching authority which, when coupled with section 105(a),[134] allows the court to be most accommodating where the factors to be considered under section 304(c) warrant.

Code section 304(c) says that "[i]n determining whether to grant relief under subsection (b) the court shall be guided by what will best assure an economical and expeditious administration of such estate" consistent with six factors listed therein.[135] Notice again that the estate with which the court should concern itself must be the foreign estate, because no domestic estate exists in an ancillary proceeding.[136] The factors, not explicitly exclusive, in statutory order are:

(1) "just treatment of all holders of claims against or interests in such estate;"
(2) "protection of claims holders in the United States against prejudice and inconvenience;"
(3) "prevention of preferential or fraudulent dispositions of property·"

127. 11 U.S.C. § 304(a) (2000).
128. *Id.* at § 304(b)(1)(emphasis added).
129. *Id.* at § 304(b)(2).
130. *Id.* at § 362(a).
131. *Id.* at § 304(b)(3).
132. *Id.* at §362(a).
133. *Id.* at § 304(b)(3) and text at note 131.
134. "The court may issue any order, process, or judgment that is necessary or appropriate to carry out the *provisions of this title* (emphasis added).
135. *Id.*
136. *Id.*

(4) "distribution of proceeds of such estate substantially in accordance with the order prescribed by this title;"
(5) "comity" and
(6) "if appropriate, the provision of an opportunity for a fresh start for [an] individual."137

It is noteworthy that comity merely appears as the fifth of six factors, which are not arranged in any discernable order. It is as if comity was an afterthought, or is merely one of several equal considerations. Some courts have so treated it, but other courts have considered comity the paramount factor, with the other five factors designated to carry it out.[138] As I have demonstrated, comity is largely a matter of political sensitivity in international relations with no particular structure. Perhaps, in the future, it is sufficient if courts develop a federal common law of comity, with content similar to developed choice of law principles.

The other factors, seen as attempting to guide the choice of relief to be accorded, may be an advance. The problem is that it is unclear as to the goal of factorial inquiry We are told that the court is to seek the economical and expeditious administration of the foreign estate. This goal must be achieved consistent with comity and the other factors. Is the court to apply foreign law or domestic law? How do you balance "just treatment of *all* holders"[139] of claims or interests against the protection of U.S. claim holders against prejudice and inconvenience? And, what does it mean to require distribution of the foreign estate "substantially in accordance with the *order* prescribed by this title?"[140] As Professor Buxbaum has put it:

> Unfortunately, section 304 does not incorporate a principled choice-of-law approach. There are two distinct areas in which the absence of a conflicts method is apparent. First, Section 304 does not instruct courts to consider the interests, relative or absolute, of the United States and any foreign jurisdiction in the application of their respective laws to the bankruptcy proceeding. In other words, a local proceeding initiated by a small local creditor when the debtor and all other creditors are located in a single foreign jurisdiction is not distinguished from a local proceeding brought by a large group of U.S. creditors when the debtor has major local operations and other substantial contacts with the United States.[141]

Indeed, the 304 factors do not consider the foreign interests at all, except to the extent they are considered via the single word "comity

My purpose is not, however, to review the courts struggle to apply the factors. As is often the case with legislation, which does not fully address a problem, the courts are occasionally very creative in dealing with these often complex questions, but are also sometimes very parochial in a biased application of U.S. law. I will now turn to a few selected cases to illustrate the law in action.

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137 11 U.S.C. § 304(c).
138. *See* Harrison, *supra* note 125, at 10-13.
139. 11 U.S.C. § 304(c)(1).
140. *Id.* at § 304(c)(4).
141. Buxbaum, *supra* note 2, at 32.

*B. Selected Cases*

An early case under BRA 1978 was *In re Toga Manufacturing Ltd.*[142] In a back handed manner, this case essentially decided that Canadian bankruptcy law would not be applied to a garnishment lien claimed in a fund then in the clerk's office of a Michigan state court.[143] There is no conflicts analysis, little discussion of Bankruptcy Code section 304 factors, and a rigid application of section 304(c)(4).[144] Here, an American creditor had contracts with the debtor as an exclusive sales representative for auto parts from three major automobile manufacturers.[145] Alleging withheld commissions, the creditor sought arbitration and eventually secured two arbitration awards.[146] Meanwhile, Toga's major secured creditor took control of its business and assets and appointed a receiver.[147] The arbitration awards were confirmed by order of a Michigan state court, and writs of garnishment were served on the three automobile manufacturers.[148] The secured creditor intervened in the garnishment proceedings, claiming that the funds, eventually ordered paid into the court, were subject to its prior perfected security interest in Toga's accounts receivable.[149] The state court found the secured party's security interest was superior to the garnishment liens, and directed the funds be paid to the Canadian receiver.[150] The American creditor appealed and was granted a stay [151] A few months later, an unsecured creditor filed an involuntary bankruptcy petition in Canada.[152] The Canadian receiver was appointed trustee in Canada, and brought an ancillary proceeding under section 304 in the Eastern District of Michigan, seeking a stay and the turnover of the garnished funds.[153]

Applying Canadian law, the court found the fund was property of the Canadian bankruptcy estate.[154] It then addressed the question of what effect should be given to claims based on Canadian law to property located in the United States.[155] The court simply starts on the wrong foot.

Citing *Harrison v. Sterry*[156] and *Odgen v. Saunders*,[157] the court opined that "[h]istorically, the bankruptcy laws of our country have been hostile toward claims asserted by foreign trustees in bankruptcy against alleged property located in the

142. *In* re Toga Mfg. Ltd., 28 B.R. 165 (Bankr. E.D. Mich. 1983).
143. *Id.* at 170-71.
144. *See id.*
145. *Id.* at 165-66.
146. *Id.* at 166.
147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.* at 166-67.
152. *Id.* at 166.
153. *Id.* at 166-67.
154. *Id.* at 167
155. *Id.* at 166.
156. Harrison v. Sterry, 9 U.S. 289 (1809).
157 Odgen v. Saunders, 25 U.S. 213 (1827) (not dealing with an international insolvency but with an interstate matter).

United States."[158] Not cited, and hence ignored, was *Gebhard*,[159] which bound domestic bondholders to a Canadian proceeding on the clear universalist attitude of more recent law.[160] Of course, the court was not without support in other uncited cases. But, the court seemed to ignore the universalist factors in section 304. When it turned to section 304 it listed the subsection (c) factors and discussed some of them.[161] Although holding that the American creditor "would receive just treatment of its claim against Toga in the Canadian courts,"[162] it did not discuss the balance for which this factor calls. Section 304(c) does not merely call for just treatment of the American creditor,[163] but for the "just treatment of all holders of claims against such estate."[164] This treatment is the universalist notion of a single proceeding with equality of treatment of all creditors. The court's mistake appears when it concludes that the American creditor will not receive distribution "substantially in accordance with the order prescribed by this title."[165] It reaches this conclusion because the American creditor, held by the Michigan state trial court to be a subordinated secured creditor, would be considered unsecured under Canadian law [166] Thus, the court construes section 304(c)(4) as requiring treatment for an American creditor by the foreign law very similar to that accorded by U.S. law.[167] I submit that is not what this subsection requires.

In the first place, if section 304(c)(4) requires substantially identical treatment of individual creditors under both laws, there is never a role for conflict of laws. This approach is the forum law approach, where the forum always applies its own law. Secondly, the language of the rule requires the distribution of estate proceeds be in accord "with the *order* prescribed by"[168] title 11—not that each creditor be treated in the same class that it would be under U.S. law. Whether a creditor is secured or not depends upon the applicable law; applicable law is a choice of law issue. For example, while in the United States most states follow the Uniform Commercial Code on the attachment and perfection of consensual security interests and its choice of law rules,[169] the broader rule of the Restatement of Conflicts provides that for chattels, the law of the state with the most significant relationship applies, and that is generally, in the absence of an effective choice, the law of the "location of the chattel at the time that the security interest attached."[170] The "order" of distribution is a matter of bankruptcy law. I think, *Toga* reflects

158. Toga, 28 B.R. at 167.

159. Canada S. Ry. Co. v. Gebhard, 109 U.S. 527 (1883).

160. *Id.*

161. *Toga*, 28 B.R. at 166.

162. *Id.*

163. It does call for the American court to protect against "prejudice and inconvenience. 11 U.S.C. § 304(c) (2000).

164. *Id.*

165. *Toga*, 28 B.R. at 169.

166. *Id.* at 168-69.

167. *Id.*

168. 11 U.S.C. § 304(c)(4) (2000).

169. *See id.* § 9-301(1) (1998) (which generally adopts the law of the debtor's location to issues of perfection and priority).

170. RESTATEMENT (SECOND) OF CONFLICTS § 251 (1971).

inattention to the issue actually presented, whether turning the money over to the Canadian trustee would lead to the economical and expeditious administration consistent with a distribution of proceeds, not substantially dissimilar to the order provided in the U.S. Bankruptcy Code.[171] It does not call for every creditor to fall within the distribution order that U.S. law provides.

Another case with a territorial bias is *Interpool Ltd. v. Certain Freights of the M/V Venture Star*.[172] This case has more of a choice of law aspect. KKL Kangaroo Lines (KKL) was an Australian shipping company.[173] Wah Kwong owned ship leasing companies in Hong Kong, which leased ships to KKL.[174] Involuntary liquidation proceedings were initiated by Wah Kwong in Australia.[175] At the time, KKL had property in the United States, including certain freight monies and the proceeds of a pending arbitration between KKL and Weyerhauser Company.[176] A Liquidator was appointed by the Australian courts.[177] In pre-liquidation transactions, KKL assumed the business of another company and agreed to pay its creditors.[178] The other company transferred the arbitration claim to KKL, and KKL received a $6 million loan from a Wah Kwong subsidiary secured by an assignment of the arbitration rights.[179] The relationship of the parties was complex and the repayment terms unclear.[180] The KKL's business deteriorated and it subsequently ceased doing business.[181] Wah Kwong went into receivership.[182] Two agreements were entered into between various parties, including the KKL Liquidator and certain Wah Kwong subsidiaries.[183] The agreements essentially provided that the proceeds of the arbitration would be paid to the Liquidator, who would then pay a Wah Kwong subsidiary the first $6 million, while the rest would be held for the Australian bankruptcy.[184] These agreements were approved by the Australian court apparently without notice to the U.S. creditors.[185]

The Liquidator petitioned for ancillary proceedings under section 304 in the District of New Jersey Bankruptcy Court.[186] Then, various petitioning creditors filed an involuntary chapter 7 petition in the Central District of California.[187] The District Court for New Jersey entered an order which stayed all actions against the

171. The order provided in the Bankruptcy Code is: secured creditors, priority creditors, unsecured creditors, and equity owners.

172. Interpool Ltd. v. Certain Freights of M/V Venture Star, 102 B.R. 373, 374 (D.N.J. 1988).

173. *Id.* at 374.

174. *Id.*

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.* at 375.

179. *Id.*

180. *Id.*

181. *Id.* at 376.

182. *Id.*

183. *Id.*

184. *Id.* at 375.

185. *Id.* at 376.

186. *Id.* at 375.

187. *Interpool Ltd.*, 102 B. R. at 375.

debtor, withdrew to the District Court the reference of the 304 petition, consolidated all actions in that court, and appointed a receiver to collect the outstanding freights and pay them to the Court Registry.[188] Shortly thereafter, the bankruptcy court in California transferred the chapter proceeding to the New Jersey district court.[189] The reported decision involved the Liquidator's motion to dismiss the chapter 7 proceeding.[190]

The court says that "[t]here is no requirement that Australian law and United States law be identical."[191] As I will show, it is hard not to agree with Charles Booth. In discussing *Interpool* on this point Booth says, "[t]his assertion to the contrary, the *Interpool* opinion, in effect, sets forth the requirement that for section 304 relief to be granted, the foreign law *must* be identical to the U.S. law."[192]

The court starts out reviewing Australian liquidation law and concludes that "access to Australian courts relating to actions of the Liquidator is not restricted."[193] But, the court noted that briefs, affidavits, and testimony indicated that creditors could not seek to set aside the Liquidator's agreements concerning the arbitration proceeds.[194] The court then said that "[p]rotection of United States creditors is of utmost importance to this Court. Actions taken by a foreign court in a foreign bankruptcy are to be given deference *if, and only if,* there would be no substantial violation of the law that would be applied in the United States."[195]

Looking at section 304, the court ordered the petition granted: "this Court must be convinced that the foreign Court has or will abide by fundamental standards of procedural fairness."[196] Then, referring to the Federal Rules of Bankruptcy Procedure, the court noted that they required notice to creditors "prior to the institutionalization of agreements between the trustee and any of the creditors, and that the "trustee and creditors hold a series of meetings."[197] The court finally concluded:

> Since, in this case, the creditors were not notified prior to the date the Court ratified the agreement between the Liquidator and Wah Kwong, this Court finds that the procedural protections available to creditors in the United States were not given to the United States creditors in Australia. This is a serious omission.[198]

Of perhaps more importance, the court found that the doctrine of equitable

188. *Id.*

189. *Id.* at 375, fn. 3.

190. 11 U.S.C. § 305(a)(2)(B) (2000).

191. *Interpool Ltd.*, 102 B.R. at 378.

192. Charles D. Booth, *Recognition of Foreign Bankruptcies: An Analysis and Critique of the Inconsistent Approaches of United States Courts*, 66 AMER. BANKR. L. J. 135, 204 (1992) (emphasis in original).

193. *Interpool Ltd.*, 102 B.R. at 378.

194. *Id.*

195. *Id.* (emphasis added).

subordination was not available in Australia and might be implicated in the Liquidator's agreement with Wah Kwong.[199] Therefore, the court concluded that "[b]oth the laws and the public policy of the United States will be violated if the case is permitted to proceed under Australian law Foreign trustees will be able to enter into any type of agreements as long as United States law, notions of due process, and equitable treatment of creditors are followed in a similar fashion in foreign jurisdictions."[200]

Consequently, the court denied the section 304 petition and granted the chapter 7 petition.[201] Again, there is a total failure to undertake anything but a territorial analysis. There is no serious conflict analysis, nor is the statutory injunction concerning economical and expeditious administration discussed. The court fails to note the inherent conflict left where U.S. law claims the worldwide assets of KKL are property of the U.S. bankruptcy estate in the chapter 7 proceeding. Indeed, the court mistakenly says that "[a]ll of the assets located in the United States, including, but not limited to the proceeds of the [arbitration] claims, shall be considered part of the bankrupt estate. "[202] Why the arbitration claims are considered located within the U.S. is not mentioned, nor are conflict of laws issues concerning the validity of the various foreign claims to the arbitration proceeds. Booth points out a number of Australian protections for creditors which, while different, would be weighed in any choice of law analysis considering the interests of the various states.[203] Finally, there is no recognition that there remains a choice of law question—whether Bankruptcy Code section 510 on equitable subordination is the proper law to apply to a transaction between a foreign liquidator, an alleged insider, a foreign debtor with property in the United States, which was entered into abroad. It seems that while the district court reached a decision, the rationale had little to do with principles capable of reaching a predictable, fair, and economical result in an international insolvency.

The next case I survey demonstrates a far better use of section 304 and includes a little choice of law analysis. In *In re Culmer* [204] Judge Lifland dealt with a petition under section 304 by Bahamian liquidators of a Bahamian bank ("BAOL").[205] BAOL's banking license was suspended in the Bahamas on July 16, 1982.[206] On August 16, a stockholder's resolution called for the winding-up of the firm, and a court-supervised liquidation was commenced in the Bahamas on that day [207] On September 8, the section 304 petition for ancillary relief was filed.[208] In addition, the bankruptcy court issued two temporary restraining orders on that day and on the 10th, which stayed actions against BAOL or its property in the United

199. *Id.*.
200. *Id.* at 380.
201. *Id.*
202. *Id.*
203. Charles D. Booth, *supra* note 192, at 206-07
204. *In* re Culmer, 25 B.R. 621 (Bankr. S.D. N.Y 1982).
205. *Id.* at 622.
206. *Id.* at 623.
207. *Id.*
208. *Id.*

States[209] This property was in various forms, but centered on accounts in various U.S. financial institutions.[210] The U.S. creditors were largely claiming under ex *parte* attachments or setoffs,[211] and some opposed granting the prayed for relief.[212] The relief requested was to stay the commencement or continuation of all actions against BAOL's property in the United States, and require the turnover of all property to the Bahamian proceedings.[213]

The court discussed the progress of the Bahamian proceedings and found them to be "inherently fair and regular."[214] The issues were largely discussed on the implicit assumption that the choice was to defer to the Bahamian proceedings and the assumed application of Bahamian law to all issues, or to dismiss the section 304 proceeding and let the American courts apply American law.[215] The court does not really address this issue, which detracts from an otherwise fine opinion.

The court seriously addressed the section 304(c) factors essentially treating them as aspects of international comity.[216] The court recognized the universalist direction of section 304 by stating: "[i]t is this Court's opinion based upon the wording and legislative history of section 304 that the central examination which it must undertake in order to comply with Section 304(c) is whether the relief petitioners seek will afford equality of distribution of the available assets."[217] In addressing comity, the court not only quoted the oft-quoted definition in *Hilton v. Guyot*,[218] but quoted New York cases, which state the exceptions to comity more narrowly: "foreign-based rights should be enforced unless the judicial enforcement of such a [right] would be the approval of a transaction which is inherently vicious, wicked or immoral, and shocking to the prevailing moral sense."[219]

Applying this strong notion of comity, the court examined Bahamian insolvency law and found it generally in accord with U.S. concepts, even though the Bahamian notion of priority claimants is not the same as that in the United States.[220] Thus, in some cases, American creditors would not be given the same distribution they would receive if U.S. laws were applied. The court did a factor by

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209. *Id.*.

210. *Id.*

211. *Id.*

212. *Id.*

213. *Id.*

214. *Id.* at 627.

215. *Id.* at 627-29

216. *Id.* at 629 ("All of the factors listed in Section 304(c) have historically been considered within a court's determination whether to afford comity to proceeding in a foreign nation ").

217. *Id.* at 628.

218. *Hilton*, 159 U.S. at 164.

219. *Culmer* 25 B.R. at 629 (quoting from Int'l Hotels Corp. v. Golden, 203 N.E.2d 210, 212 (N.Y 1964) *as quoted in* Cornfeld v. Investors Overseas Serv., Ltd., 471 F.Supp. 1255 (S.D.N.Y 1979)). Interestingly, Golden was case dealing with a foreign gambling contract and the actual word used by the New York court where Culmer shows "[right]" was "contract" which was changed to "[right]" by the district court in Cornfeld. *Cornfeld*, 471 F Supp. at 1259. It is possible that international comity owes less respect to foreign law than to a foreign contract.

220. *Culmer*, 25 B.R. at 628-29.

factor analysis under section 304(c) and concluded "that affording comity would not violate American law or public policy Whether or not Bahamian law is identical in application to American law, there is nothing inherently vicious, wicked, immoral or shocking to the prevailing moral sense in the Bahamian laws outlined above."[221]

Finally and most important to the themes of this article, the court briefly addressed the reason that the Bahamian law should be applied to the instant transactions.[222] The court said:

> Moreover, the Bahamas has by far the greatest interest in BAOL's liquidation since neither the United States nor the State of New York has any governmental or public interest in BAOL's liquidation. In contrast, only a handful of creditors who have purported to obtain preferences in this district have opposed transferring all of BAOL's assets for distribution in the Bahamian liquidation. This court is thus not obliged to protect the positions of fast-moving American and foreign attachment creditors over the policy favoring uniform administration in a foreign court.[223]

This analysis is not a detailed choice of law analysis, but it is an improvement on the apparent dichotomy between deferring or dismissing. It adds measurably to the section 304(c) factors, which call for weighing some of the relevant factors, but ignores the weighing of the competing legal interests, which seek to choose the law of the nation with the greater interest. Admittedly, choice of law analysis has not reached anything approaching a litmus test; however, neither has most law. The choice of law analysis would also suggest using the distinction between jurisdiction, which section 304 primarily addresses, albeit with substantive concerns, and applicable law. For instance, nothing in the law of nations requires American courts to insist on leaving assets in the United States for administration in order to get to consider the American notion of equitable subordination.[224] Is the lack of such a doctrine inherently vicious, wicked, immoral, or shocking? More importantly might the Australian court in *Interpool* [225]consider applying the American doctrine in the case before it? This question is the type of choice of law done daily in domestic and other international areas of law Why not international insolvency? In fact, it is done in international insolvency cases by a properly focused court, albeit not always with the clearest approach. To focus more directly I now turn to a grand case.

In early 1996, before the Second Circuit's decision in *In re Maxwell Communication Corporation*,[226] but after the district court's affirmance[227] of the bankruptcy court's granting a motion to dismiss for failure to state a claim,[228] Jay

221. *Id.* at 631.
222. *Id.* at 629.
223. *Id.* at 629.
224. *See* Interpool Ltd. V Certain Freights of the M/V Venture Star, 102 B.R. 373 (D.N.J. 1988).
225. *Id.*
226. *In re* Maxwell Communication Corp., 93 F.3d 788 (2d Cir. 1996).
227. *In re* Maxwell Communication Corp., 186 B.R. 807 (S.D.N.Y 1995) (Judge Scheindlin).
228. *In re* Maxwell Communication Corporation, 170 B.R. 800 (Bankr. S.D.N.Y 1994) (Judge

Lawrence Westbrook wrote: "[t]he *Maxwell* case as a whole is one of the most important transnational insolvencies of modern times."[229] This judgment has not needed to change with the passage of seven years—at least in reported cases. The very interesting facts are well presented in the three opinions. I will only lightly sketch the facts important to my use of the case for choice of law purposes. In so doing, I follow the Second Circuit's factual presentation.

Robert Maxwell was a media magnate with his activities centered in England, but with international holdings.[230] His death led to the bankruptcy of the Maxwell Communication Corporation plc, an English corporation ("Maxwell").[231] While most of Maxwell's debt was incurred in England, eighty percent of its assets were located in the United States.[232] These assets included Macmillan, Inc. and other entities.[233] On December 16, 1991, Maxwell filed a chapter 11 petition.[234] The next day, it petitioned the High Court of Justice in London for an administration order, the closest equivalent in British law to Chapter 11 relief.[235] With two large multiparty proceedings pending in England and the United States,[236] the two courts did a remarkable thing—they cooperated in a sophisticated manner. Judge Brozman appointed an examiner:

> [The examiner was] to investigate the debtor's financial condition, to function as a mediator among the various parties, and to 'act to harmonize, for the benefit of all of [Maxwell's] creditors and stockholders and other parties in interest, [Maxwell's] United States chapter 11 case and [Maxwell's] United Kingdom administration case so as to maximize [the] prospects for rehabilitation and reorganization.'[237]

More remarkably, the two courts approved a protocol between the Examiner and the Administrators.[238] In light of the protocol, Judge Brozman recognized the Administrators as the corporate governance of the debtor-in-possession in the United States, and the English judge granted the Examiner leave to appear in the English proceedings.[239] The parties worked together to develop a plan for reorganization and a scheme of arrangement (hereinafter, collectively referred to as the "Plan") as interdependent documents which were filed for approval in both countries.[240] The Plan treats all of the world-wide assets as a pool under the control

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Brozman)

229. Jay Lawrence Westbrook, *The Lessons of Maxwell Communication*, 64 FORDHAM L. REV 2531, 2534 (1996); *In* re Maxwell Communications Corp.,93 F.3d 1036, 1041 (2d Cir. 1996).

230. *In re* Maxwell Communications Corp., 93 F.3d 1036, 1041 (2d Cir. 1996).

231. *Id.* at 1040.

232. *Id.*

233. *Id.*

234. *Id.*

235. *Id.*

236. *Id.* at 1041-42.

237. *Id.* at 1042.

238. *Id.*

239. *Id.*

240. *Id.*

of Maxwell for distribution.[241] It basically pays the secured creditors and holders of priority claims in full.[242]

Three banks, subjects of the instant preference actions, filed claims with the Administrators.[243] One of these banks had sought an anti-litigation injunction in England.[244] After receiving an *ex parte* order, the injunction was vacated by the English court.[245] In the U.S. case, the Administrators then commenced adversary proceedings against the three banks for the recovery of allegedly preferential transfers.[246]

As might be expected in large international transactions, the transfers were complex. The three banks were: Barclays Bank plc, and National Westminster Bank plc, both headquartered in London with branches in New York, and Societe Generale, a French bank with headquarters in Paris and offices in London and New York.[247] Barclays and National Westminster had separately negotiated overdraft facilities in London.[248] When an extension on the overdraft became past due, Barclays pressured Maxwell into making a $30 million payment from proceeds of the sale of a Macmillan subsidiary.[249] These proceeds, on deposit in a Maxwell account at the New York branch of National Westminster, were transferred to Maxwell's dollar account with National Westminster in London, and from there, to Barclays New York branch, and then credited to Maxwell's overdraft account in London.[250] Other similar transfers were also alleged.[251]

In National Westminster's case, Maxwell had sold another Macmillan subsidiary for $145 million.[252] These dollars had been deposited with Citibank in New York, from which they were transferred to a Maxwell account with Citibank in London.[253] Maxwell then purchased British pounds and used some of these to deposit in an account it had at National Westminster's London branch.[254] The deposit was then used to pay down the overdraft facility [255] Another similar set of transfers were made to National Westminster.[256]

Societe Generale had negotiated a loan in London with Maxwell.[257] Maxwell made a payment of $10 million in pounds by transferring the pounds from another

241. *Id.*
242. *See* E. Bruce Leonard, *Breakthroughs in Court-to-court Communications in Cross-border Cases*, A.B.I. J. vol. 20 no. 7, 18 (Sept. 2001)( for more on the use of cooperation).
243. *In re* Maxwell Communications Corp., 93 F.3d 1036, 1043 (2d Cir. 1996).
244. *Id.* at 1042-43.
245. *Id.*
246. *Id.* at 1043.
247. *Id.* at 1040.
248. *Id.*.
249. *Id.*
250. *Id.* at 1040-41.
251. *Id.*
252. *Id.* at 1041.
253. *Id.*
254. *Id.*
255. *Id.*
256. *Id.*
257. *Id.*

account maintained in London to Societe's branch in London.[258] Although the details of this transaction were unclear, the district court assumed these funds had also come from the sale of one of the Macmillan subsidiaries.[259]

All of the actual transfers to the banks had been made within ninety days preceding the chapter 11 filing.[260] Despite the close cooperation and judicial approval of the plan and scheme, neither court addressed the question of what law would be applied in any avoidance actions. While there are many similarities between U.S. and English preference rules, there was one large difference that apparently would decide the instant actions.[261] Under the English Insolvency Act of 1986,[262] preference avoidance requires that the debtor intends the transfers to place the transferee in a better position.[263] Of course, this subjective element is absent from present U.S. preference law. A classic choice of law issue was presented and so treated by Judge Brozman of the bankruptcy court through the circuit court. They are to be commended.

What did they decide? They decided the English preference law was the applicable law after seriously engaging in a proper choice of law analysis.[264] This case was not an ancillary proceeding case, so the section 304 factors were not directly applicable.[265] Instead, the Second Circuit started with international comity, citing the usual cases, but adding from *Hilton*:

> [I]nternational law, including questions arising under what is usually called private international law, or the conflict of laws, and concerning the rights of persons within the territory and dominion of one nation, by reason of acts, private or public, done within the dominions of another nation, is part of our law.[266]

The court noted that comity does not limit sovereignty, but aids construction of the law.[267] Essentially, in the absence of a clear congressional command, conflict of laws rules guide the determination of what law to apply [268] As always, the conflict of laws of the forum is determinative.

The court considered section 403 of the Restatement of Foreign Relations discussed above. While these are textual rules limiting the state's jurisdiction to prescribe, the Court said that the "factors enumerated in the *Restatement* correspond to familiar choice-of-law principles,"[269] and specifically referred by parenthetical quotation from another Second Circuit case that the "rule is to apply

258. *Id.*
259. *Id.*
260. *See id.* at 1040-41.
261. *See id.* at 1051.
262. *Id.* at 1043.
263. *Id.*
264. *Id. at* 1041-47
265. *Id.*
266. *Id.* at 1047, *quoted* in Hilton v. Guyot, 159 U.S. 113 (1895).
267. *Id.* at 1046-47
268. *Id.* at 1047
269. *Id.* at 1048.

the law of the jurisdiction having the greatest interest in the litigation."[270] Thus, they rapidly developed comity into consideration of the Restatement of Foreign Relations and equated that in essence to the "greatest interest" rubric.[271]

The court then rejected a number of tenuous, but plausible, textual arguments for the proposition that Congress had expressed itself.[272] The court specifically rejected the notion, implicit in many lower court cases—that "the Bankruptcy Code always applies, comity notwithstanding, when a bankruptcy case has been properly commenced, and that choice-of-law analysis is never appropriate in a bankruptcy case."[273] The court rejected this notion because it could find no code-based language supporting that broad proposition and rejected the interpretation proffered by two older cases.[274]

It next considered the "false conflict" analysis suggested by the Supreme Court in its narrow decision applying American anti-trust law to activities in England, on the basis that the conduct prescribed by American anti-trust law was not illegal in England in *Hartford Fire Insurance*,[275] discussed above. It did so by closely analyzing the scope and purposes of avoidance rules.[276] Essentially, the court properly recognized that the purpose of preference rules is to try to more closely assure that the estate of an insolvent debtor is equitably distributed by avoiding certain transactions shortly before bankruptcy, and sharing the avoided transfers with creditors as a whole.[277] As such, "a conflict between two avoidance rules exists if it is impossible to distribute the debtor's assets in a manner consistent with both rules."[278] Thus, it avoided the snare of "false conflicts" that often confuses courts in ordinary cases, both where a conflict is not real, and where it is real (if you look closely at related rules like distribution to creditors).

Finally the court undertook a careful weighing of interests in traditional conflict of laws fashion.[279] It noted that the debtor, and most creditors, were British.[280] While the funds had a transient location briefly in the United States (if today monies in deposit accounts are located anywhere other than via an artificial legal rule[281]), and may have been proceeds of sales of U.S. assets, these factors did

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270. *Id.* Second quotation is from *In re* Koreag, Controle et Revision S.A. v. Refco F/X Assocs., 961 F.2d 341, 350 (2d Cir. 1992).

271. *See* Mathias Reimann, *Savigny's Triumph? Choice of Law in Contracts Cases at the Close of the Twentieth Century*, 39 Va. J. Int'l L. 571 (1999) (for more on the globalization of the greatest interest or most significant relation including contacts and policies at least in contract choice of law cases).

272. *In re* Maxwell Communications Corp., 93 F.3d 1036, 1048 (2d Cir. 1996).

273. *Id.* at 1049.

274. *See id.* at 1048-49.

275. *Id.* at 1049-50.

276. *Id.*

277. *Id.*

278. *Id.* at 1050.

279. *Id.* at 1051.

280. *Id.*

281. *Cf.* Rev. U.C.C. § 9-304 (local law of bank's jurisdiction governs perfection of security interest in a deposit account).

not particularly weigh in favor of applying U.S. avoidance law.[282] The court emphasized that not applying U.S. law was, in part, affected by the fact that these assets had been sold as going concerns with no discernable effects on local economies.[283] The court stated:

> The principal policies underlying the Code's avoidance provisions are equal distribution to creditors and preserving the value of the estate through the discouragement of aggressive pre-petition tactics causing dismemberment of the debtor. These policies are effectuated, although in a somewhat different way, by the provisions' [§ 547] British counterpart.[284]

The decisions (including those of the district and bankruptcy courts) are a refreshing approach to the choice of law dilemma; they recognized that the decision was properly analyzed based on choice of law principles, sought guidance in the policies of the Code, and sought to follow the paltry prior guidance of the Supreme Court. Jay Westbrook disagrees somewhat arguing for the application of the home country's avoidance rules. Westbrook admits that, in *Maxwell,* the home country was arguable and that a particularized application of choice of law analysis might have been the only way out.[285] I am not averse to a true universalist regime where the proper forum would be selected by some rule, and that state's law applied; however, I am more sympathetic to the notion that traditional choice of law principles seek to allocate interests and policies as they best fit a particularized case. Perhaps, the actual conflict is between principles of treating creditors alike, and treating an individual creditor justly, a substantive accommodation will be needed and found. I tend to believe, for now, that the common law choice of law approach will better inform our eventual collective judgment.

Not discussed by the Second Circuit is whether New York or federal choice of law rule should be applied. Maybe there was no salient difference, or maybe, as seems the case, federal rules were assumed to apply.[286] The bankruptcy court applied federal common law.[287] This issue was better considered by the Second Circuit in the next case.

In *Koreag, Controle Et Revision S.A. v. Refco F/XAssociates, Inc.*,[288] the court faced the question of how to decide whether property located in the United States is property of the foreign bankruptcy estate.[289] Koreag was the official liquidator of Mebco Bank S.A., a Swiss bank.[290] Refco was a New York commodity and currency corporation.[291] Prior to Mebco being placed into liquidation by Swiss authorities on April 27 1989, Mebco and Refco engaged in extensive currency

282. *See In re* Maxwell Communications Corp., 93 F.3d 1036, 1051 (2d Cir. 1996).
283. *Id.*
284. *Id.* at 1052.
285. Westbrook, *supra* note 229, at 2541.
286. *In re* Maxwell Communications Corp., 93 F.3d 1036 (2d Cir. 1996).
287. *Id.* at 1042-43
288. *See In re* Koreag, Controle et Revisone S.A., 961 F.2d 341 (2d Cir. 1992).
289. *Id.* at 344.
290. *Id.*
291. *Id.*

transactions.[292] Typically, and especially in the instant dispute, the parties used an account in the Swiss Bank-NY (the "Account") through which currency transactions cleared.[293] Both Mebco and Refco were buyers and sellers of various currencies.[294] In essence, the disputed fund (U.S. dollars) had been wire transferred into the Account on the afternoon of April 28th, the day after Mebco was placed into liquidation, Koreag appointed, and before Refco had notice of the Swiss proceedings.[295] Mebco was then expected to transfer to Refco bank accounts abroad foreign currencies of the same amount.[296] Also, without notice of the liquidation proceedings, Refco transferred foreign currencies to Mebco's European accounts for which Mebco was to transfer dollars of an equal amount to the Account.[297] "The net result of these aborted currency exchanges is that Refco transferred approximately $6.9 million into the Account, and approximately $4.1 million worth of foreign currency to overseas Mebco accounts, for which Mebco failed to make reciprocating transfers [the "Disputed Funds"]."[298] Upon learning of the liquidation proceedings, Refco obtained an *ex parte* attachment of the Account and moved for confirmation of the attachment.[299] Koreag then intervened, seeking comity to the Swiss proceedings and the dismissal of the attachment proceedings.[300] The district judge suggested that a section 304 petition was the better way to proceed, which Koreag promptly filed.[301] In its petition, it sought an injunction against further efforts by Refco to reach the Account and an order to turn the Account over to Koreag for administration in Switzerland.[302] The bankruptcy court granted Koreag summary judgment and the district court affirmed.[303] The Second Circuit vacated and remanded.[304]

On appeal, Refco argued that the Disputed Funds were not property of the foreign estate, and that even if they were, the lower courts had improperly applied the section 304(c) factors.[305]

Section 304(b)(2) authorizes the bankruptcy court in an ancillary proceeding to "order turnover of the property of *such estate, or the proceeds of such property,* to such foreign representative."[306] The court resolved this question principally on the ground that Collier's on Bankruptcy clearly read the statute to provide that "[f]or purposes of section 304, the estate of a foreign debtor is defined by the law of the jurisdiction in which the foreign proceeding is pending, *with other*

292. *Id.*
293. *Id.* at 344-45.
294. *Id.*
295. *Id.* at 345.
296. *Id.* at 344-45.
297. *Id.*
298. *Id.* at 345.
299. *Id.* at 346.
300. *Id.*
301. *Id.*
302. *Id.*
303. *Id.* at 346-47 (2d Cir. 1992).
304. *Id.* at 347.
305. *Id.*
306. 11 U.S.C. § 304(b)(2) (2000)(emphasis added).

*applicable law serving to define the estate s interest in particular property.*"[307] The court found this analogically supported by reference to domestic cases where the actual interest of the debtor is defined by state law, even though section 541(a) takes a broad approach to property of the estate[308] Thus, the court determined that a prerequisite to turnover under section 304(b)(2) is a determination by the U.S. bankruptcy court that the property sought to be turned over is property of the foreign debtor.[309]

Should Swiss or New York law apply? The court noted that there was some dispute in the cases as to what choice of law rules should apply—federal common law or state law.[310] Finding both applied an interest analysis, there was no need to resolve the issue.[311] Applying interest analysis, the court found that both New York and Switzerland were interested in the dispute.[312] Refco was located in New York, Refco performed in New York, the disputed funds were in New York,[313] and "New York as a world financial center has a special concern with transactions such as occurred here."[314] While Switzerland was interested in the administration of Mebco's estate, its interest did not especially implicate the property issue at stake.[315] Thus, New York law was to be applied in determining the competing claims to the Disputed Funds.[316]

Refco asserted two claims: one for a constructive trust over the Disputed Funds, and the other for the right to reclaim by a seller under former Uniform Commercial Code (herein "UCC") section 2-207(2).[317] The court found that a plausible case for constructive trust had been made under New York law and remanded with the "practical burden" on Koreag to show why a constructive trust should not be imposed.[318] Turning to the reclamation issue, the court rejected Koreag's claim that Refco had to comply with Bankruptcy Code section 546(c) because an ancillary proceeding under section 304 was not a full bankruptcy, section 546 authorized the trustee or debtor-in-possession to proceed, and the foreign representative was neither.[319] However, the court concluded the UCC did not prevent the foreign currencies transfer from being property of Mebco's estate and were therefore subject to turnover under section 304(b)(2).[320] The court

307. *Koreag*, 961 F.2d at 348 (quoting 2 Collier on Bankruptcy ¶ 304.01, at 304-3 (15th Ed. 1992)(emphasis added).

308. *Id.* at 348-49.

309. *Id.* at 349.

310. *Id.* at 350.

311. *Id.*

312. *Id.* at 351.

313. Actually, this is unclear. The Disputed Funds included by definition of the court both the dollars Refco transferred into the Account and the foreign currencies transferred into foreign bank accounts of Mebco.

314. *Koreag*, 961 F.2d at 351.

315. *Id.*

316. *Id.*

317. *Id.*

318. *Id.* at 352-55.

319. *Id.* at 356.

320. *Id.* at 356-57.

concluded:

> If Refco prevails on the constructive trust issue upon remand, none of the Disputed Funds will be subject to turnover. If Koreag prevails on that issue, only the portion of the Disputed Funds involved in the [foreign currencies transfer] will be subject to turnover. Under any view of the relative weight to be accorded the pertinent § 304(c) factors, turnover would be a permissible exercise of discretion as to those funds.[321]

In my judgment, *Koreag* is a good example of conflicts analysis in an international insolvency case. I cannot be as complimentary to the next decision, at least as to its analysis.

The Tenth Circuit recently decided *In re Grandote Country Club Company, Ltd.*[322] Like so many international insolvencies, the facts are relatively complex. A golf course located in Colorado was originally owned by a U.S. group known as "Grandote Colorado, who failed to pay certain Colorado taxes in 1990. [323] A member of the group sold the property to a person who then sold it subject to tax liens to Grandote Country Club, Ltd. ("Grandote Japan"-the debtor in Japanese bankruptcy proceedings) in February 1993.[324] In May 1994, Grandote Japan conveyed the property back to Grandote Colorado (the "Japan to Colorado transfer").[325] Another party purchased tax certificates, who then conveyed them to still another, who then brought a successful forcible entry and detainer action against the property [326] Grandote Japan declared bankruptcy in July 1994 and its trustee filed a section 304 ancillary petition and received recognition sufficient to bring the instant action, contending that the Japan to Colorado transfer was avoidable under Japanese law and seeking to avoid the Tax Deeds under Colorado's Uniform Fraudulent Transfer Act.[327] The district court granted summary judgment in favor of the defendants.[328]

The Tenth Circuit, in a confusing opinion on this issue, perhaps reached a correct result, by discussing section 304(c), and noting the goal of providing relief in an ancillary proceeding is to "assure an economical and expeditious administration."[329] It then turned to "two competing values principles of comity, which favor application of Japanese law, [and] the interests of the locality where the property is located, which favor application of United States/Colorado law."[330] The court noted that the bankruptcy court in the section 304 proceeding had found Japanese bankruptcy law consistent with the principle features of U.S.

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321. *Id.* at 358-59.
322. *In re* Grandote Country Club Co., 252 F.3d 1146 (10th Cir. 2001).
323. *Id.* at 1148.
324. *Id.*
325. *Id.* at 1149.
326. *Id.*
327. *Id.*.
328. *Id.*
329. *Id.* at 1150.
330. *Id.*

law.[331] Citing *Koreag,* but hardly following it, the court drew on its statement that "local law [should] determine whether the debtor has a valid ownership interest in that property when the issue is properly posed by an adverse claimant."[332] It cites *Koreag*, and Colorado law, for the proposition that the law of the state with the greatest interest should be applied.[333] It then concludes that "Colorado has the greatest interest" because of the property's location, the tax proceedings, and the execution of most of the documents.[334] Nowhere does the court consider, or even mention, the Japanese interest in recovering the debtor's property for the benefit of creditors. It may be that seriously considering the Japanese interest would leave the decision with Colorado law. But, it is not possible to determine which state has the greatest interest without looking at the interests of both states and the competing policies. Moreover, while it mentions it does not consider the federal policy seeking to further the "economical and expeditious administration" of the debtor's estate.[335] The court, unlike the Second Circuit in *Koreag,* simply fails to engage the applicable law. It then concludes that the tax deeds were not avoidable under the Colorado Uniform Fraudulent Transfer Act.[336]

Another interesting decision is *Hong Kong and Shanghai Banking Corp., Ltd. v. Simon.*[337] This majority opinion in *Simon* is arguably a little confused, but it reaches the right result and is not actually a choice of law case. The debtor Simon was a Hong Kong resident and businessman when he personally guaranteed a corporation's large debt, for which, he was the major shareholder.[338] The debt was guaranteed to the Hong Kong Shanghai Banking Corp., Ltd. ("HKSB") and was part of a Hong Kong transaction.[339] Hong Kong law was the law chosen in the guarantee.[340] Greatly in debt, Simon moved to the United States and eventually filed for personal chapter 7 [341] The HKSB guarantee was listed in the schedules, but HKSB did not file a proof of claim on that claim, but on a different one.[342] HKSB is an international bank incorporated in Hong Kong, with offices in New York and California.[343] The bankruptcy court granted Simon a discharge and issued an injunction in accord with the discharge injunction of Bankruptcy Code section 524(a)(2).[344] Two weeks later, HKSB filed a complaint seeking a declaratory judgment, that the discharge injunction did not reach its efforts to pursue Simon personally abroad on his guarantee, or to claim against non-estate

331. *Id.*
332. *Koreag*, 961 F.2d at 349 (as *quoted* in *Grandote Country Club*, 252 F.3d at 1151).
333. *Grandote Country Club*, 252 F.3d at 1151.
334. *Id.*
335. *Id.* at 1150-51.
336. *Id.* at 1151-52.
337. *In re* Simon, 153 F.3d 991 (9th Cir. 1998).
338. *Id.* at 994.
339. *Id.*
340. *Id.*
341. *Id.*
342. *Id.*
343. *Id.*
344. *Id.*

property abroad on the guarantee.[345] The bankruptcy court held against HKSB, and was affirmed by the district court.[346]

The court had some difficulty in the first part of the opinion, to which there was a dissent by Judge Hall.[347] The court first determined whether Congress had acted clearly to overcome the presumption against extraterritoriality.[348] In an extended discussion, it concluded that via section 541 (a) Congress had in fact intended to assert the bankruptcy court's jurisdiction *in rem* over the property of the debtor wherever it is located.[349] The case law relied on is largely domestic, and not international.[350]

Judge Hall reasoned that section 541(a)'s generality did not in fact reach everywhere, and that the Supreme Court had adopted rules of construction to avoid possible clashes with international law.[351] More importantly, that was not the issue in *Simon*. The court did not need to reach property in Hong Kong. It needed to bind HKSB which had offices in California, had filed a proof of claim with the bankruptcy court and over whom the bankruptcy court had personal jurisdiction.[352] That is clearly enough to bind HKSB to the injunction. The majority finally turned to this issue and concluded similarly.[353] Before finishing, however, it considered international comity.[354]

The discussion on comity is quite good, even though this case is not a case of choice of law. American law in final form and without appeal had enjoined HKSB.[355] The issue was whether this injunction, with extraterritorial effects, violated the international comity between courts.[356] This case was not an attempt to enjoin a foreign court. Here the court cited, but did not discuss, the Restatement of Foreign Relations section 403(1),[357] and instead followed *Maxwell* for the proposition that this case did not deal with the question of deference to a foreign proceeding, but was rather a case where the United States was unquestionably the situs of a plenary bankruptcy proceeding, to which Hong Kong might need to defer.[358] The court stated:

> The Bankruptcy Code does not codify either of the theories proffered by the parties [territoriality or universalism]. Rather, the Code provides for a flexible approach to international insolvencies dependent upon the circumstances of the particular case. If any philosophy can be attributed to the structure of the Code it

345. *Id.*
346. *Id.* at 994-95.
347. *Id.* at 999.
348. *Id.* at 996
349. *Id.*
350. *See id.*
351. *Id.* at 999-1000.
352. *Id.* at 994.
353. *Id.* at 999.
354. *Id.* at 997-99.
355. *Id.* at 999.
356. *Id.* at 998.
357. *Id.*
358. *Id.* at 998-99.

> is that of deference to the country where the primary insolvency proceeding is located, including the United States if the plenary proceeding is located here.[359]

While this quote can be presented as the question of what law to apply to the question of discharge, U.S. law or foreign law (unlikely where the debtor is an individual domiciled in the U.S.), it is better seen as a reflection of the fact that the bankruptcy discharge actually operates as an injunction against a broad range of enforcement activities.[360] Thus, the discharge issue is predominantly one of personal jurisdiction. The harder question in *Simon* would have been the application of the discharge injunction to a non-resident of the United States, who had no property in the United States, and who did not file a proof of claim. In such a case, personal jurisdiction would be dubious and, in any event, extraterritorial enforceability is practically impossible.

In the next case, the Court of Appeals for the Second Circuit did not address the choice of law issue and seemingly took a step back toward the territoriality view of section 304 by emphasizing one of the subsections over the others, rather than balancing the factors.[361] The court also implicitly assumes, which may be correct in context, that forum law will govern many of the legal issues.[362]

In *The Bank of New York v. Treco*,[363] the court faced a typically complex case of an insolvent Bahamian bank.[364] The bank, Meridien International Bank Limited ("MIBL"), controlled a number of banks primarily located in Africa.[365] It had a relationship with the Bank of New York and JCPL Leasing Corp, a subsidiary of The Bank of New York Company, Inc. and affiliates ("BNY").[366] MIBL pledged its accounts with BNY in the June 1993 MIBL Pledge Agreement.[367] Later, MIBL arranged an overdraft relation with BNY in the ultimate amount of $15.15 million.[368] This overdraft account was secured by funds deposited with BNY by a MIBL subsidiary, Meridien BIAO Bank Tanzania ("Meridien Tanzania"), and pursuant to an agreement (the "Meridien Tanzania Agreement").[369] When MIBL defaulted on the overdraft obligation, BNY liquidated the Meridien Tanzania pledged account.[370] This liquidation occurred in March 1995.[371]

In April 1995, the Central Bank of Tanzania appointed a manager to operate Meridien Tanzania, who challenged the Meridien Tanzania Agreement and demanded the return of the $15.15 million.[372] On April 25, 1995, MIBL was placed

359. *Id.* at 998.
360. 11 U.S.C. § 524 (2000).
361. *See In re* Treco, 240 F.3d 148 (2d Cir. 2001).
362. *Id.*
363. *Id.* at 148.
364. *Id.* at 151-52.
365. *Id.*
366. *Id.*
367. *Id.*
368. *Id.*
369. *Id.*
370. *Id.* at 152.
371. *Id.* at 151-52.
372. *Id.*

into involuntary liquidation in the Bahamas and Liquidators were appointed.[373] In June 1995, BNY filed an action in the Southern District of New York against MIBL, Meridien Tanzania, and several other subsidiaries (the "District Court Action").[374] This action sought a declaratory judgment that BNY had the right to retain the Meridien Tanzania liquidated account, or in the alternative, an order allowing BNY to essentially setoff the $600,000 remaining in MIBL's BNY accounts.[375]

In September 1995, the Bahamian Liquidators filed an ancillary proceeding under section 304, seeking a stay of all actions against MIBL and the turnover of all of MIBL's U.S. assets.[376] The Bankruptcy Court issued a preliminary injunction in March 1996, and the District Court action proceeded against the remaining defendants.[377] That action was settled, BNY agreed to pay $4 million to Meridien Tanzania's assignee, and BNY was assigned all Meridien Tanzania's rights of subrogation against the MIBL accounts.[378]

In the meantime, the Liquidators' right to the turnover of the $600,000, BNY's claims against the $600,000 for its payment of the $4 million to Meridien Tanzania's assignee, and BNY's subrogation rights acquired from Meridien Tanzania, came to a head in the Liquidators' motion for partial summary judgment.[379] The bankruptcy court granted the Liquidators' motion on January 22, 1999 [380] On appeal, this decision was affirmed by the district court on September 10, 1999 [381]

The Courts' decisions were reversed by the Second Circuit.[382] Both Bahamian and U.S. law recognized the status of a secured creditor.[383] Under Bahamian law, however, numerous administrative claims have priority over the claims of secured creditors.[384] On the facts of the case, the supremacy of administrative claims over secured creditors was problematic for BNY Here, the Liquidators had recovered approximately $10 million and incurred administrative expenses of almost $8 million, leaving $1 75 million in the estate.[385] The administrative claims were routinely paid without notice to creditors.[386] Thus, there was a substantial likelihood that BNY would recover only a small portion of its $600,000 secured

373. *Id.*
374. *Id.*
375. *Id. at* 152.
376. *Id.*
377. *Id.*
378. *Id.* at 152-53.
379. *Id.* at 153.
380. *Id., see also In re* Treco, 229 B.R. 280 (Bankr. S.D. N.Y 1999) (Judge Garrity) (the bankruptcy court's opinion covers many issues not decided on appeal and is worthy of careful study).
381. *In re* Treco, 239 B.R. 36 (S.D.N.Y 1999).
382. *See In re* Treco, 240 F.3d 148 (2d Cir. 2001); *In re* Treco, 239 B.R. 36 (S.D.N.Y 1999).
383. *See In re* Treco, 240 F.3d at 152-53.
384. *Id.* at 155
385. *Id.* at 159.
386. *Id.*

claim, if ultimately recognized as secured, in the Bahamian proceeding.[387]

The court recognized that section 304 "was a step toward the universality approach."[388] It described the approach as "a primary insolvency proceeding instituted in the debtor's domiciliary country, [with] ancillary courts in other jurisdictions [deferring] to the foreign proceeding and in effect [collaborating] to facilitate *the centralized liquidation of the debtor s estate according to the rules of the debtor s home country.*"[389] But, the court also stated that "[s]ection 304 does not implement pure universality "[390] Rather, the court notes, the statute endorses the five factors of analysis in section 304(c) noted above.[391]

In dealing with the structure of section 304(c), the court noted that while "comity is the ultimate consideration in determining whether to provide relief," that "comity does not automatically override the other specified factors."[392] Thus, section 304(c) "calls for a case-specific exercise of discretion in light of all of the circumstances."[393] Unfortunately, this statement inherently means that no precedent provides clear guidance for the future, unless the facts are very similar. This statement also means that settlement, or the avoidance of litigation, is not aided by reasonably clear case law For the Second Circuit, the structure of section 304(c) requires a court to "determine whether comity should be extended to the foreign proceeding in light of the other factors."[394] This quote of course adds nothing to the language of the statute.

The court thus rejected the Liquidators' argument that the case called for a straightforward comity analysis (whatever that would be!). In doing so, the court in my mind amazingly said:

> [w]e think the proper question to ask is whether § 304(c)(4) [whether the foreign distribution priority is 'substantially in accordance with the order' prescribed by U.S. law], along with the other factors, requires the court to deny turnover in the circumstances of this particular case, despite its goal of assuring an economical and expeditious administration of foreign estates.'[395]

This statement seems hard to square with the basic structure and language of section 304(c). It seems to interpret this subsection to say that the goal in providing relief, or turnover, of the economical and expeditious administration of the estate, is limited by the five factors. Indeed, the case as a whole, with its fact specific analysis, seems to raise the order of distribution in the U.S. Bankruptcy Code to the status of a trump in ancillary cases.

The Court concedes that "the first three factors present no bar to affording

387. *Id.* at 159.
388. *Id.* at 154.
389. *Id.* at 153 (emphasis added).
390. *Id.* at 154.
391. *Id.* at 154-55, 158-60.
392. *Id.* at 156.
393. *Id.*
394. *Id.*
395. *Id.* at 157.

comity to the proceedings in the Bahamas."[396] Again, notice the use of the factors, not as a basis of analysis for the exercise of the discretion for which comity calls, but as limits on the deference adopted as the general rule in international insolvency cases. Thus, the Court, like the lower courts, was quite satisfied with the procedures, non-discrimination, and prevention of preferences available in the Bahamas.[397] While conceding that the priority rules need not be identical in both countries in order for deference to attach, that is nevertheless the sole basis here for refusing to defer. The court noted the high risk that the administrative costs would eat up the estate and leave nothing for even a secured creditor.[398]

The court assumed BNY's claims were secured for purposes of the section 304 analysis.[399] It now noted that that decision had not been made below and that the case needed to be remanded for that determination.[400] It also noted that because a right to a setoff resulted in a secured claim under U.S. bankruptcy law,[401] the lower court would also have to determine that issue apparently under U.S. law.[402] Since the Bankruptcy Code does not create any setoff rights,[403] but only recognizes those that exist under other law,[404] the court should have left open the question of whose law determined the right of any setoff. Moreover, it is not obvious that if a setoff right exists, its status as secured must be determined by U.S. law. After all, the status of a claim under the Bankruptcy Code is for the purposes of the Bankruptcy Code, and not necessarily for the purposes of the economical and expeditious administration of a foreign estate in an ancillary proceeding.[405] The court simply used section 304 as the exclusive statement of all factors to be considered in ancillary cases.[406] That was not the approach in *Maxwell*,[407] but then *Maxwell* was a plenary chapter 11, and not an ancillary proceeding governed by section 304.[408]

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396. *Id.* at 158.

397. *Id.* at 158-61.

398. One reading of § 304(c)(4)'s reference to the order of distribution is that the class order must be substantially the same not that an individual creditor would receive the same or substantially similar distribution. Courts have not focused on this distinction but it seems necessarily implied. Otherwise, § 304(c)(4) collapses all foreign insolvency cases to cases where U.S. courts would defer only when the foreign distribution to the U.S. creditor is both procedurally fair by U.S. standards, *i.e.* like U.S. standards, and that creditor would receive substantially the same distribution. This is not much of a step towards universality or comity.

399. *See In re* Treco, 240 F.3d at 161.

400. *Id.*

401. 11 U.S.C. §506(a) (2000).

402. *See In re* Treco, 240 F.3d at 161.

403. *See* 11 U.S.C. § 553 (2000).

404. *Id.* at §553.

405. Cf. *id.* § 304(c).

406. *In re* Treco, 240 F.3d at 153-61.

407. *In re* Maxwell Communications Corp., 93 F.3d 1036 (2d Cir. 1996).

408. *Id.*

## V CHOICE OF LAW OR JURISDICTION SELECTION PRINCIPLES?

The Model Law on Cross-Border Insolvency was adopted by the United Nations Commission on International Trade Law ("UNCITRAL") on May 30, 1997 [409] The Model Act has been the basis of the proposed Title 15 of the United States Code in various bankruptcy bills.[410] It basically calls for greater cooperation in cross-border insolvencies, strengthens the express tools of the U.S. bankruptcy courts, and adopts a number of procedures to make the process more predictable.[411] It has little to do with choice of law issues. In this sense, I am critical, but not surprised. Conflicts scholars for some time have noted the paucity of legislation for domestic conflict of laws cases with little success.[412] Statutory choice of law rules are rare in the United States,[413] although they are becoming more frequent and more coherent in Europe.[414] As the global economy grows and becomes ever more constant in the lives of many businesses and their attorneys, the problems briefly mentioned in this article will become more regular, and the courts will be forced to seek more coherent and predictable rules. The construction of these rules will require the efforts of many.

Some versions of Universality call for the selection of a single forum for insolvency proceedings. Implicitly and explicitly, the law would be that of the forum, but this rule does not necessarily follow Applying a single state's law in a conflicts setting would make matters somewhat less complex; however, it would also merely force parties to do battle over the forum selection process. With so much Territorialism in the world, this solution would not solve much. The traditional conflicts of laws approach divides the work of issues into jurisdiction, effect of foreign judgments, and choice of laws.[415] In the insolvency setting, I believe that this scheme is in use, but only in the background because it is not clearly acknowledged. An insolvency proceeding conceptually has four aspects: (1) collection of the estate; (2) determination of claims against the estate; (3) some system of priority of distribution of the limited assets; and (4) procedures for handling these matters. The procedures have traditionally been those of the forum.[416] It would seem that there should be a single scheme for the distribution of the limited assets of an insolvent estate hence, the strength of the universalist appeal. The nature of the estate's interests in property, and the legitimacy and

409. *See* 36 Int'l Law Materials 1386 (1997) *(*for text of Model Act).

410. *See* 36 Int'l Law Materials 1386 (1997); Current version is Title VIII, H.R. 975, 108th Cong. (2003).

411. 36 Int'l Law Materials 1386 (1997).

412. Roger C. Cramton, David P Currie, Herman Hill Kay, and Larry Kramer, CONFLICT OF LAWS, 90 (5th Ed. 1993) and Robert A. Leflar, 44 Tenn. L. Rev. 951, 951 (1977).

413. Cf. Revised U.C.C. § 9-301(2) adopting the location of collateral for the perfection, effects of perfection, and priorities for certain transactions.

414. Reiman, *supra* note 271.

415. RESTATEMENT (SECOND) CONFLICT OF LAWS p. XI-XXVII.

416. *Id.* at § 122.

value of creditor claims seem to be matters on which substantive law varies throughout the world and, hence, calls for a choice of law analysis. As noted above, the basic choice of law guidelines for (1) and (2) exist in state and federal law Items (3) and (4) are at least somewhat covered by section 304.[417]

In this article I have tried to show that federal choice of law principles have had limited impact in cross-border insolvency cases. Too many courts have become embroiled in trying to work out the factorial elements of Bankruptcy Code § 304(c) in order to determine whether to grant the relief allowed in ancillary cases by § 304(b), and the insoluble question whether § 304(c)(1), (2), (3), (4), and (6) are independent of or examples of (5)(comity). In doing so the principle goal of "an economical and expeditious administration of such estate" in § 304(c) is diminished. As statutory law, of course, § 304 prevails where it is intended to do so. But it is too much to assume from the text that § 304 is intended to be complete and to exclude choice of law principles whose function is to decide what law determines what issues.

In conclusion, I only can hope that focusing on the absence of and utility of choice of law principles will inform future judicial and academic consideration of cross-border issues.

417 11 U.S.C. § 304(b)(3) (2000).

# THE EFFECTIVENESS OF THE WORLD BANK'S ANTI-CORRUPTION EFFORTS:

# CURRENT LEGAL AND STRUCTURAL OBSTACLES AND UNCERTAINTIES

*Parthapratim Chanda**

## I. INTRODUCTION

Corruption is widely considered the single most severe impediment to development and growth in developing countries.[1] Corruption in developing countries is not simply a domestic problem, but often involves a variety of actors within and outside of developing countries. Curbing cross-border, or transnational, corruption through legal channels raises unique legal and administrative issues of jurisdiction, investigative cooperation and conflict of laws that may not exist in purely domestic anti-corruption efforts. These issues have led to numerous multilateral efforts to control transnational corruption, including the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions,[2] the Inter-American Convention against Corruption,[3] and the United Nations Convention against Corruption,[4] all of which require countries

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1. Cheryl W Gray & Daniel Kaufmann, *Corruption and Development*, FINANCE AND DEVELOPMENT, Mar. 1998, at 7. ("In recent survey of more than 150 high-ranking public officials and key members of civil society from more than 60 developing countries, the respondents ranked public sector corruption as the most severe impediment to development and growth in their countries.").

2. Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, Dec. 17, 1997, S. TREATY DOC. NO. 105-43 (1997), 37 I.L.M. 1 (1998), *available at* http://oecd.org/dataoecd/41/242031210.pdf (last visited Feb, 8, 2004) [hereinafter OECD Convention].

3. Inter-American Convention against Corruption, Mar. 29, 1996, S. TREATY DOC. NO. 105-39 (1996), 35 I.L.M. 724 (1996), *available at* http://www.oas.org/juridico/English/Treaties/b-58.html (last visited Feb. 6, 2004) [hereinafter Inter-American Convention].

4. United Nations Convention Against Corruption, G.A. Res. 58/4, U.N. GAOR, 58th Sess., U.N. Doc. A/RES/58/4 (2003), *available at* http://untreaty.un.org/English/notpubl/Corruption_E.pdf (last visited Feb. 16, 2004) [hereinafter U.N. Convention].

to criminalize corrupt activity and urge cooperation between nations to investigate and prosecute transnational corruption.[5]

In 1996, the World Bank[6] joined these multilateral efforts by publicly announcing an institutional commitment to combat corruption within the World Bank and within World Bank financed projects carried out by governments in the developing world.[7] Disbursing over $19 billion in loans per annum,[8] the World Bank is exposed to significant operational risk for corruption and fraud. For example, Northwestern University political economist Jeffrey Winters estimates that corruption diverted upwards of 30 percent of development funds lent to Indonesia by the World Bank, totaling over $11 billion.[9] Several high-profile cases involving multinational Western firms in World Bank financed projects confirm the transnational nature of such corruption. In 2000, for example, the World Bank suspended its support for a $100 million water project in Ghana awarded to a unit of Enron Corporation, citing an unexplained $5 million payment by Enron.[10] Additionally the World Bank raised objections to Enron projects in Nigeria, India and Mozambique.[11]

While a vast and developing literature attempts to define corruption and address its causes and consequences,[12] the World Bank assigns its own meaning to the terms "corruption" and "fraud" in its Procurement Guidelines and Consultant Guidelines. The definitions set forth by the Bank in the Procurement Guidelines,

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5. OECD Convention, *supra* note 2, at art. 9; Inter-American Convention, *supra* note 3, at art. II(2); U.N. Convention, *supra* note 4, at art. 1.

6. For the purposes of this article, "World Bank" or "Bank" solely denotes the International Bank for Reconstruction and Development (IBRD), the largest organization under the World Bank Group structure. *See* World Bank Group, About Us, Organization, Five Agencies, One Group, *at* http://www.worldbank.org/ (last visited Feb, 16, 2004). The World Bank Group also includes the International Finance Corporation, the International Development Association, the Multilateral Investment Guarantee Agency, and the International Centre for Settlement of Investment Disputes. *Id.*

7 WORLD BANK, HELPING COUNTRIES COMBAT CORRUPTION: PROGRESS AT THE WORLD BANK SINCE 1997 1 (2000) [hereinafter PROGRESS SINCE 1997].

8. 1 WORLD BANK, ANNUAL REPORT 2002 8 (2002). Figure combines IBRD and IDA lending.

9 Jeffrey A. Winters, *Criminal Debt*, *in* REINVENTING THE WORLD BANK 101, 102 (Jonathan R. Pincus & Jeffrey A. Winters eds., 2002). *See also* Jane Perlez, *Ahead of Re-election Run, Indonesia President Is Chased by Corruption Complaints*, N.Y TIMES, Jan. 26, 2003, at 8 ("The concerns about corruption come with many news reports this week that 20 percent of World Bank and other foreign loans are siphoned off every year by the Indonesians.").

10. *Justice Eyeing Enron in Bribe Probe*, CBS News, Aug. 5, 2002, *available at* http://www.cbsnews.com/stories/2002/08/20/national/printables519319.shtml (last visited, May 1, 2004).

11. John R. Wilke, *Enron Criminal Probe Focuses On Alleged Corruption Abroad*, WALL ST. J., Aug. 5, 2002, at A1. *See also* Karen MacGregor, *Acres Loses Appeal on Bribery Charge in Lesotho*, GLOBE AND MAIL, Aug. 18, 2003, at B3 (Acres International, Canadian multinational engineering firm, lost an appeal of a conviction on bribery charges related to a World Bank financed water project).

12. *See generally* Ibrahim F.I. Shihata, *Corruption: A General Review with an Emphasis on the Role of the World Bank*, 15 DICK. J. INT'L L. 451, 453-59 (1997) (describing corruption from the perspectives of economics, political science, law, sociology, public administration, and business); David Kennedy, *The International Anti-Corruption Campaign*, 14 CONN. J. INT'L L. 455 (1999) (proposing that current definitions of corruption may be over-inclusive).

which are nearly identical to the Consultant Guidelines, are as follows:

> (i) "corrupt practice" means the offering, giving, receiving, or soliciting of any thing of value to influence the action of a public official in the procurement process or in contract execution; and
>
> (ii) "fraudulent practice" means a misrepresentation of facts in order to influence a procurement process or the execution of a contract to the detriment of the Borrower, and includes collusive practices among bidders (prior to or after bid submission) designed to establish bid prices at artificial, non-competitive levels and to deprive the Borrower of the benefits of free and open competition.[13]

While the definition of corrupt practice does not explicitly prohibit outside parties from corruptly influencing World Bank staff,[14] the World Bank Staff rules provide that "[s]taff members shall not accept in connection with their appointment or service with the Organizations any remuneration, nor any benefit, favor or gift of significant value from any such governments or other entities or persons ..."[15] The Staff Rules further state that "[n]either a staff member nor a member of his immediate family shall accept a direct financial interest in any Bank Group transaction ..."[16] The rules also define staff misconduct to include the "[m]isuse of Bank Group funds or other public funds for private gain in connection with Bank activities or employment, or abuse of position in the Bank for financial gain."[17]

In accordance with these provisions, the World Bank Sanctions Committee carries out sanctions for violations of the Procurement Guidelines, Consultant Guidelines and Staff Rules.[18] Allegations of corruption or fraud are first investigated by the Department of Institutional Integrity (INT),[19] an allegedly independent office within the World Bank that reports directly to the President of the Bank.[20] If INT believes there is reasonably sufficient evidence of fraud or

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13. World Bank, Guidelines: Procurement under IBRD Loans and IDA Credits, § 1.15(a) (1999), *available at* http://www.worldbank.org/ (last visited Feb. 6, 2004) [hereinafter Procurement Guidelines]. *See also* World Bank, Guidelines: Selection and Employment of Consultants by World Bank Borrowers, § 1.25(a) (1999), *available at* http://www.worldbank.org/ (last visited Feb. 6, 2004) [hereinafter Consultant Guidelines].

14. It is also unclear whether the term "public official" in the World Bank's definition of corrupt practice includes World Bank staff members.

15. World Bank, Staff Manual, Staff Rules, § 0.01, Principle 3.1(b) (1999) [hereinafter Staff Rules].

16. *Id.* at § 3.01, ¶ 7.01.

17. *Id.* at § 8.01, ¶ 3.01(d).

18. World Bank Group, Sanctions Committee Procedures, § 1(a)(3) (2001), *available at* http://www.worldbank.org/ (last visited Feb. 6, 2004) [hereinafter Sanctions Committee Procedures].

19. *Id.* at § 3(a).

20. *See* U.S. GEN. ACCOUNTING OFFICE, WORLD BANK: MANAGEMENT CONTROLS STRONGER, BUT CHALLENGES IN FIGHTING CORRUPTION REMAIN, GAO DOC. NO. NSIAD-00-73, at 12 (2000) (finding World Bank's Investigation Unit did not have the necessary independence from the Bank s president. While reforms were subsequently undertaken by the World Bank to create a more independent structure for investigations, it is unclear whether the GAO's conclusions have been repudiated), *available at* http://www.gao.gov/ (last visited Mar. 22, 2004) [hereinafter GAO REPORT].

corruption, it can refer the matter to the Sanctions Committee for punitive measures.[21]

The World Bank Staff Rules provide that "termination of service shall be mandatory where it is determined that misuse of Bank funds or other public funds for private gain in connection with Bank activities or employment, or abuse of position in the Bank for financial gain" has occurred.[22] The Procurement and Consultant Guidelines include provisions allowing the World Bank to retract an award or contract if a bidder has engaged in corrupt or fraudulent practices in the bidding or execution stages of the award or contract.[23] The World Bank may also declare a firm or individual ineligible, indefinitely or for a stated period of time, to secure a Bank-financed contract.[24] Currently one hundred seventy-one firms and individuals are debarred, either permanently or for specified periods of time, from receiving World Bank-financed contracts.[25] The Bank does not maintain a public list of the names or the number of staff members who have been terminated for fraud and corruption.[26]

Given its prominence in the world of development finance and its status as the first development finance organization to implement a comprehensive anti-corruption regime, the World Bank assumed a leadership position in the movement to eliminate corruption from the field of international aid. Despite its successes, however, significant legal and structural obstacles and uncertainties threaten the effectiveness of the World Bank's anti-corruption efforts. This article analyzes a number of these obstacles and uncertainties including the expansive due process rights of employees and unclear procedural requirements imposed on the Bank during criminal referrals, uncertainties surrounding the standard of proof in internal corruption proceedings, the lack of a system of investigative cooperation and cross-debarment and structural impediments arising out of the Bank's operational model, governance structure, oversight capacity and staff incentives. In the face of these obstacles and uncertainties, this article also offers recommendations for the World Bank to improve its anti-corruption practices.

21. Sanctions Committee Procedures, *supra* note 18, at § 3(c).

22. Staff Rules, *supra* note 15, at § 8.01, ¶ 4.01.

23. Procurement Guidelines, *supra* note 13, at §§ 1.15(b)-(c); Consultant Guidelines, *supra* note 13, at §§ 1.25(b)-(c).

24. Procurement Guidelines, *supra* note 13, at § 1.15(d); Consultant Guidelines, *supra* note 13, at § 1.25(d).

25. World Bank Group, Projects, Procurement, List of Debarred Firms, World Bank Listing of Ineligible Firms: Fraud and Corruption, *at* http://www.worldbank.org/ (last visited Apr. 15, 2004).

26. *See* World Bank Group, Preventing Corruption in World Bank Projects, *at* http://www1.worldbank.org/publicsector/anticorrupt/preventing.htm (last visited Feb. 12, 2004).

## II. LEGAL OBSTACLES AND UNCERTAINTIES SURROUNDING CRIMINAL REFERRALS OF ALLEGED CORRUPT ACTIVITY

### *A. Background to the Practice of Criminal Referrals at the World Bank*

Criminal sanctions have traditionally been a part of the legal regime to combat corruption in individual nations.[27] All of the major international agreements against corruption require signatory governments to criminalize corrupt activity.[28] In the United States, criminal referral of corrupt activity to local and federal prosecutors is an established tool for ensuring the integrity of those institutions.[29] Following this bureaucratic norm, the World Bank began to refer allegedly corrupt activity to national prosecutorial bodies.

In two 2002 cases, former World Bank employees pled guilty in the United States District Court for the District of Columbia to felony counts related to corrupt activity they engaged in while employed at the World Bank.[30] The U.S. Department of Justice's prosecution of these two individuals was initiated via criminal referrals from the World Bank's Legal Department.[31] The cases also mark the first two instances of employees of an international organization being prosecuted under the Foreign Corrupt Practices Act. In the first case, *United States v. Sengupta*,[32] the defendant, Gautam Sengupta, pled guilty to one count of conspiracy to commit wire fraud in violation of 18 U.S.C. § 371 and to a second count in violation of the Foreign Corrupt Practices Act, 15 U.S.C. § 78dd-3.[33] The World Bank employed Mr. Sengupta as a Task Manager in Washington D.C. from 1993 to 2000.[34] "Task Managers are responsible for individual development projects and as one of their duties ensure that proper feasibility studies are

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27 Philip M. Nichols *The Myth of Anti-Bribery Laws as Transnational Intrusion*, 33 CORNELL INT'L L.J. 627, 629 (2000) ("Bribery is universally condemned and is criminalized by every country in the world.").

28. *See* OECD Convention, *supra* note 2, at art. 1 Inter-American Convention, *supra* note 3, at art. II; U.N. Convention, *supra* note 4, at art. 1.

29. *See* Thomas E. Holliday & Charles J. Stevens, *Disclosure of Results of Internal Investigations to the Government or Other Third Parties, in* INTERNAL CORPORATE INVESTIGATIONS 279, 283-92 (Brad D. Brian & Barry F McNeil eds., 2003) (noting disclosure of criminal activity is required of certain highly regulated industries and for companies dealing in securities while other companies may disclose voluntarily).

30. *See* A.B.A., WHITE COLLAR CRIME 2003 506-49 (2003) (providing the Plea Agreement and Statement of Facts for both cases and the Information for *United States v. Basu*).

31. Glenn T. Ware, Lecture at Harvard Law School (Apr. 11, 2003) (presentation on file with author).

32. Both the Plea Agreement and Statement of Facts for *United States v. Sengupta* were filed in the United States District Court for the District of Columbia on January 30, 2002. A.B.A., *supra* note 30, at 506, 519.

33. A.B.A., *supra* note 30, at 506.

34. *Id.* at 519.

completed for each proposed project."[35] In his role as Task Manager, Mr. Sengupta entered into a scheme whereby he caused the awarding of four contracts to a Swedish consultant in exchange for kickback payments totaling $127,000.[36] For one of the contracts, Mr. Sengupta assisted the Swedish consultant in wiring $50,000 to a Kenyan official overseeing the implementation of a World Bank project, with knowledge that the payment was a kickback,[37] in violation of the Foreign Corrupt Practices Act.[38]

In the second case, *United States v. Basu*,[39] the defendant, Ramendra Basu, pled guilty to identical counts of conspiring to commit wire fraud in violation of 18 U.S.C. § 371 and to violating the Foreign Corrupt Practices Act, 15 U.S.C. 78dd-3.[40] Mr. Basu served as an officer in the Consultant Trust Funds Office at World Bank headquarters in Washington, D.C. from 1996 to 2000, except for approximately three months in late 1997.[41] As a Trust Funds officer, the defendant's duties included recommending consultants to Task Managers and approving Task Managers' requests for Consultant Trust Funds."[42] In this capacity, Mr. Basu met with the Swedish consultant and Mr. Sengupta and agreed to "facilitate the payment of bribes" from the former to the latter.[43]

In September 1997 Mr. Basu left his job at the World Bank and joined the staff of the Swedish consulting firm and also secured employment there for his father, brother-in-law, and a close friend.[44] At that time, Mr. Basu agreed to receive ten percent of the value of all contracts that he worked on for the Swedish consultant.[45] By January 1998, the Swedish consultant had been awarded three contracts by the World Bank Task Manager, Mr. Sengupta.[46] In December 1997 Mr. Basu returned to his position at the World Bank, though he continued to perform work on World Bank contracts with the Swedish consultant and continued to receive compensation for his services.[47] Furthermore, Mr. Basu also played a role in facilitating the corrupt payment of $50,000 to a Kenyan government official, providing the bank account number of a Kenyan firm to whom the

35. *Id.*
36. *Id.* at 521-22.
37. *Id.*
38. *See* 15 U.S.C. §§ 78dd-1-78ff (2000) (although the defendant was convicted of aiding in the bribery of foreign official, the 1998 Amendments to the Foreign Corrupt Practices Act extend the designation of foreign official to include officials of public international organizations. This amendment extends the reach of the act to now include corrupt activity between corrupt actors and World Bank staff regardless of whether a government official in a developing country is involved).
39. The Information for *United States v. Basu* was filed in the United States District Court for the District of Columbia on November 26, 2002. A.B.A., *supra* note 30, at 525. The Plea Agreement and Statement of facts were filed on December 17 2002. *Id.* at 533, 545.
40. *Id.* at 533.
41. *Id.* at 525-26.
42. *Id.* at 545.
43. *Id.* at 546.
44. *Id.* at 547.
45. *Id.*
46. *Id.*
47. *Id.*

Swedish consultant wired the illicit payment.[48]

As of April 2004, both defendants are awaiting sentencing. In both cases, the statutory maximum sentence is "a term of imprisonment up to five years, followed by a term of supervised release of three years; a maximum fine of $250,000, and a special assessment of $100.00 for each felony count "[49] The defendants also were ordered to repay $127,000 to the World Bank as restitution to account for the loss to the institution as a result of the corrupt payments involved in the case.[50] Furthermore, the non-economic personal and reputation costs to each of the defendants who, prior to his involvement in this scheme, held prominent positions in the leading global development finance institution, are also notable.

Criminal referrals were also made in this case to Kenyan and Swedish prosecutors. While the Kenyan prosecution is still ongoing, a court in Sweden, in February 2004, sentenced two Swedish contractors to prison for 18 months and 12 months respectively for bribery [51]

The plea agreements orchestrated by the Department of Justice (DOJ) include a provision that should strengthen the World Bank's anti-corruption efforts. Both agreements require the defendants to cooperate with the World Bank in the investigation of any matter about which the defendants have knowledge. Specifically, the provision states that

> The defendant agrees to disclose completely and truthfully all information regarding his activities and those of others in all matters about which he has knowledge or hereafter acquires knowledge concerning any matter about which the United States, The World Bank, or the Government[s] of Sweden [or Kenya] may inquire. Defendant agrees to accompany agents of the United States, The World Bank, or the Government[s] of Sweden [or Kenya] to any location in order to accomplish that purpose Defendant agrees to answer all questions completely and truthfully and must not withhold any information.[52]

This provision gives the World Bank the opportunity to compel cooperation from the defendants, subsequent to their termination from World Bank employment. The provision is an especially valuable tool because the defendants would otherwise no longer be required to cooperate with World Bank investigators under the World Bank Staff Rules[53] and because the World Bank does not have the power to compel cooperation otherwise. Given the possibility that the corruption scheme in which Mr. Sengupta and Mr. Basu engaged might involve additional World Bank employees, consultants or borrower country agents, this provision allows the World Bank to continue their investigation with the assistance of the

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48. *Id.* at 548.

49. *Id.* at 534.

50. *Id.* at 507.

51. Gus Selassie, *Swedish Nationals Convicted of Bribery, Connection with World Bank-Funded Project in Kenya*, WORLD MARKETS RES. CENTRE DAILY ANALYSIS, Feb. 6, 2004.

52. A.B.A., *supra* note 30, at 508, 534-35.

53. Staff Rules, *supra* note 15, at § 8.01, ¶ 5.04 (requiring staff members to cooperate in investigations).

defendants.

This provision is an unprecedented development in the landscape of international organizations and their anti-corruption efforts. For the first time, an international financial institution assisted national prosecutors of a Member government and also helped coordinate prosecution efforts between Member governments, without an express mutual legal assistance treaty that provides for such cooperation. The World Bank's authority to do so presumably derives from its own treaty obligations under its Articles of Agreement requiring it to "make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted."[54] The deterrent and punitive value of effective criminal prosecution helps to maintain the integrity of all World Bank loans.

Although it is unclear whether the DOJ would revoke its plea agreement with the defendants if they refused to cooperate with the World Bank under this provision, the threat of revocation may be potent enough to ensure the cooperation of the defendants. The World Bank should, when possible, use this new legal assistance provision in its anti-corruption efforts while also working with the DOJ to ensure that they include and enforce the provision in future plea agreements involving World Bank employees.

The use of criminal referrals is a positive development in the World Bank's strategy to curb corruption in its projects. In addition to providing a legal instrument to secure cooperation from corrupt actors after the termination of their employment, criminal referrals provide an additional avenue by which to seek punishment for corrupt behavior, providing further deterrence of such activity

### *B. C v. International Bank for Reconstruction and Development*[55] *and Bank Disclosure Policies — Roadblocks to Effective Criminal Referral*

The World Bank is generally immune from judicial process in member State courts for matters arising out of the employment relationship.[56] To protect the employment rights of its staff, the World Bank has its own internal Administrative Tribunal that hears and grants judgments in cases brought by employees for violations of their employment contracts or terms of appointment, including staff rules and related regulations.[57] A recent decision by the Administrative Tribunal, *C v. IBRD*, addresses for the first time the issue of criminal referrals by the World Bank. The decision imposes serious limitations on criminal referrals that will

54. World Bank Group, International Bank for Reconstruction and Development, Articles of Agreement, art. III § 5, *available at* http://www.worldbank.org/ (last visited Feb. 6, 2004) [hereinafter IBRD Articles of Agreement].

55. C v. Int'l Bank for Reconstruction and Dev., Dec. No. 272 (World Bank Admin. Trib. 2002) [hereinafter *C v. IBRD*].

56. *See* Mendaro v. World Bank, 717 F.2d 610 (D.C. Cir. 1983) (analyzing World Bank Articles of Agreement, International Organizations Immunities Act, and customary international law).

57 World Bank, World Bank Administrative Tribunal, Statute of the Administrative Tribunal of the International Bank for Reconstruction and Development, International Development Association and International Finance Corporation, art. II (2001), *available at* http://wbln0018.worldbank.org/crn/wbt/wbtwebsite.nsf (last visited Mar. 22, 2004).

undoubtedly weaken the efficacy of such referrals as a punitive and deterrent tool in the Bank's anti-corruption efforts.

In the case, the Applicant was referred to the DOJ in connection with allegedly corrupt activity that had led to his termination from employment at the World Bank. The Applicant contested the decisions of the World Bank, *inter alia*, (1) "to refer the case to the DOJ for prosecution without notifying him;" (2) "to deny him access to relevant documents and evidence necessary to his defense;" and (3) "to withhold from him information in his personnel file while failing to inform him of its transfer to third parties."[58] The Tribunal held in his favor, announcing that the Bank's Staff Rules and Policy on Disclosure of Information require the World Bank to notify an employee of a criminal referral and to provide him with copies of most of the documents referred to the DOJ.[59] The Tribunal ordered the World Bank to pay the Applicant $150,000 in damages for its failure both to notify him and to provide him with documents, in addition to damages for other unrelated claims.[60]

This section reviews this decision along with the applicable World Bank administrative provisions and cites numerous flaws both in the Tribunal's reasoning and in the World Bank's policies on disclosure. In order to fully benefit from the deterrent and punitive value of criminal referrals, the Administrative Tribunal should reverse itself and the World Bank should introduce new regulations for disclosure in corruption-related criminal referrals to counter the Tribunal's holding and to reform the current regulations.

1. Referral and Notification Requirements

As an international organization, the World Bank is not governed by the laws of any nation and must rely on its administrative rules and Tribunal decisions to define the rights of its employees. These rights are codified primarily in the World Bank Staff Rules. Throughout *C v. IBRD*, the Tribunal cites World Bank Staff Rule section 2.01, paragraph 5.01 as the source of law for the World Bank's right to refer an employee to prosecutors and for that employee's right to be notified of such a referral. Staff Rule section 2.01, paragraph 5.01 states:

> The following staff records and personnel information may be released to persons outside the Bank Group without the authorization of the staff member concerned: (a) basic employment data such as name, employment status, employment dates, job title and department; (b) compensation and pension information released to member governments for tax purposes; (c) pension records made available to a consulting actuary; (d) visa status of staff and dependents reported to governmental authorities; (e) pension, benefits and salary records made available to external auditors and accountants; (f) information necessary for processing medical, workers' compensation and other insurance claims; (g) benefits information necessary to coordinate exchange or joint benefits programs, and

58. *C v. IBRD*, Decision No. 272, at ¶ 4.
59. *Id.* ¶ 25.
60. *Id.* ¶ 35.

> information necessary to coordinate benefit policies with other international organizations; and (h) information on a staff member's salary, accrued separation grant, accrued pension benefits, and designated pension and insurance beneficiaries released consistent with a final court order or request from a judicial or civil authority in cases of divorce or family maintenance to which a staff member has not responded within 30 days of the Bank Group bringing the request or order to the staff member's attention.
>
> *The Bank Group will not release other personnel information to outside parties, including member governments and their representatives, without the staff member knowledge, except in cases of emergency situations or upon advice from the Legal Department of the Bank to release information for legal proceedings or law enforcement efforts. In such cases, the staff member will be notified as soon as reasonably possible of what information is released and to whom.*[61]

The Staff Rule explicitly allows the World Bank to refer personnel information to third parties and requires the World Bank to notify an employee of the release of a narrow category of personnel information for legal proceedings or law enforcement efforts, "as soon as reasonably possible."[62] In *C v. IBRD*, the Tribunal applies this provision for the first time to an actual case and, through reasoning that is often incorrect and unclear, expands the World Bank's duty to notify employees and creates significant uncertainty about the disclosure rules in subsequent cases.

(a) Notification of the Referral to the Department of Justice

The Tribunal writes that "the disclosure requirement imposed upon the Bank by this Staff Rule covers both the fact of a referral and the content of what is being referred."[63] The Tribunal then disposes of the Applicant's claim, that the World Bank referred him to the DOJ without notification, finding that it is "clear from the record that the Applicant was aware of the fact of a referral being made to the DOJ. This was not the result of specific notification to him but transpired from the general context in which the Bank conducted its investigation and pursued its cooperation with United States and Swedish authorities."[64]

It is unclear whether the Tribunal is implying that a blanket right exists to be notified of a referral to prosecutors. Under the Staff Rule, the duty to notify an employee depends upon the type of information referred, attaching only when "other personnel information," not specified in clauses (a) through (h) of the rule, is referred. For example, if the World Bank refers only basic employment data such as the name and employment status of an employee, under clause (a) of the rule, notification to the employee of the referral would not be required.[65]

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61. *Id.* ¶ 5 (emphasis in original) (quoting Staff Rules, *supra* note 15, at § 2.01, ¶ 5.02).
62. *Id.*
63. *Id.* ¶ 7
64. *Id.*
65. *Id.* ¶ 5.

Furthermore, the Tribunal's subjective standard for notice, relying on the Applicant's awareness of the referral based on "the general context in which the Bank conducted its investigation,"[66] is unhelpful to the World Bank's legal department when referring future employees to prosecutors. The Tribunal provides no guidance on what kind of "general context" would suffice not to require notification in future cases. Given the remainder of the opinion, which holds that notification is required for the disclosure of various types of information,[67] the World Bank will probably err on the side of caution and notify the employee upon referral in future cases.

(b) Referral and Notification Requirements for Specific Documents

While Staff Rule section 2.01, paragraph 5.01 imposes a notification requirement upon the World Bank when "other personnel information" is referred, the Tribunal does not offer any definition of what constitutes personnel information for the purposes of the rule. For example, the Tribunal holds that hotel and travel information related to the Applicant's employment qualify as "other personnel information, without any factual or legal basis for considering such information personnel information.[68] The Tribunal also fails to define what is meant by "as soon as reasonably possible. It may be persuasively argued that it is unreasonable to inform an employee of the referral of information to criminal prosecutors until a formal indictment has been filed, because the risk the employee may destroy evidence, flee the jurisdiction or tamper with witnesses is such a serious one. Without any definition of "personnel information" or what is reasonable in terms of timing the notification, the World Bank's legal department must perform significant guesswork to determine what it can refer and when it must notify an employee of a referral.

While non-personnel information is not subject to Staff Rule section 2.01, paragraph 5.01, the Tribunal broadens the applicability of the rule to include non-personnel operational records. In considering the operational records referred in the case, the Tribunal writes that it "is satisfied that nothing in them relates to the accusations against the Applicant. It follows that such documents can be released without notifying him thereof."[69] The Tribunal implies that a notification requirement exists for non-personnel information if the Tribunal determines that the information is related to accusations against the Applicant. The test is a misguided expansion of the World Bank's notification requirements. The Tribunal cannot know whether the referred information relates to accusations against the Applicant simply because accusations have not been made by the DOJ. The Tribunal's test expands the notification requirements and is grounded in speculation and provides no clear rule for the World Bank legal department to follow.

66. *Id.* ¶ 7.
67. *Id.* ¶¶ 8-35.
68. *Id.* ¶ 11.
69. *Id.* ¶ 12.

Furthermore, the Tribunal announces disclosure and notification requirements for non-personnel information that may be personal in nature. The Tribunal relies on the World Bank's Policy on Disclosure of Information of March 1994, as revised effective 2002, which establishes constraints on the disclosure of information.[70] The relevant constraints, according to the Tribunal, include:

> (i) documents and information provided to the Bank only "on the explicit or implied understanding that they will not be disclosed outside the Bank, or that they may not be disclosed without the consent of the source; or even, occasionally, that access within the Bank will be limited" must be treated accordingly by the Bank;
>
> (ii) documents and records that are subject to the attorney-client privilege, or whose disclosure might prejudice an investigation, shall not be made publicly available, this constraint reflecting a general principle of privileged information even though it was explicitly introduced only in 2002; and
>
> (iii) appropriate safeguards must be maintained in order to protect the personal privacy of staff members and the confidentiality of personal information about them, all in accordance with the Principles of Staff Employment.[71]

The Tribunal finds that the existence of an express or implied condition of non-disclosure forbids the disclosure of certain non-personnel information to third parties.[72] In this case, the Tribunal finds that the release of bank records and credit card statements by private banks to World Bank investigators, with the consent of the Applicant, "was not expressly conditioned" on non-disclosure by the Bank.[73] The Tribunal also finds there was no implied understanding of non-disclosure because (a) "the disclosed information was fully available to the Applicant himself, as it originated in his own personal business"; (b) "his ability to defend himself was not jeopardized by the disclosure"; and (c) "the DOJ could in any event have subpoenaed the records in the ordinary process of discovery available in the United States legal system."[74]

The Tribunal's reasoning creates an unclear test for determining whether an implied understanding of non-disclosure exists in future cases. The Tribunal does not define what type of information could jeopardize an employee's ability to defend himself. In reality, no type of referral by the World Bank jeopardizes an Applicant's defense before the DOJ. Because the Applicant has not been indicted for any crime, he has no defense to prepare. If he is indicted, federal criminal procedure provides him adequate opportunity to respond to allegations and defend himself. His rights include the right to discovery, which includes the right to inspect all information in the government's possession, which is material to the

70. *Id.* ¶ 13.
71. *Id.*
72. *Id.* ¶ 15.
73. *Id.*
74. *Id.*

preparation of his defense.[75] The Tribunal does not consider this line of reasoning and instead creates an unclear test to determine the existence of an implied condition of non-disclosure.

Finally, the Tribunal holds that the World Bank may refer its investigative file to prosecutors, but must notify the Applicant of the referral.[76] This report includes "summaries of various interviews conducted in the context of the Bank's investigations, including interviews with the Applicant and other persons (inside and outside the Bank) implicated in the relevant events" and "other materials that came out in the course of these interviews."[77] While the Tribunal admits that the investigative report is "not related to 'personnel matters,'" it applies the notification standard for "other personnel information" of Staff Rule section 2.01, paragraph 5.01 [78] The Tribunal offers no justification for applying this notification standard to the investigative report. In the process, the Tribunal greatly expands the notification requirement imposed on the World Bank.

In looking to the Staff Rules and the Policy on Disclosure of Information to determine what may be referred to prosecutors, the Tribunal ignores the World Bank Sanctions Committee Procedures, which include a provision allowing for the disclosure of any information related to criminal activity The Procedures provide that "[i]f the Director of the INT determines that laws of member countries may have been violated by a Respondent, the Director may at any time make available to the law enforcement or administrative authorities of the countries involved any information relating to such a violation."[79] The Sanctions Committee Procedures pertain in large part to the relationship between the World Bank and its employees, as they discuss an employee's rights throughout sanctioning proceedings.[80] These procedures are a legitimate source of law for the question of the World Bank's right to refer documents to criminal prosecutors and should have been addressed by the Tribunal and deemed dispositive in favor of the Bank on the issue of the right to refer documents.[81] Instead, the Tribunal's opinion failed to mention any of these procedures.

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75. FED. R. CRIM. P 16(a)(1)(C).

76. *C v. IBRD*, Decision No. 272, at ¶ 21.

77. *Id.* ¶ 16.

78. *Id.* ¶ 18.

79 Sanctions Committee Procedures, *supra* note 18, at § 16(a).

80. *Id.* at intro.(d).

81. *Cf.* de Merode v. World Bank, Decision No. 1 (World Bank Admin. Trib.1981). In *Merode*, the Tribunal held that, in addition to other sources of law, "elements of the legal relationship between the Bank and its personnel are also to be found in the Personnel Manual, the Field Office Manual, various administrative circulars and in certain notes and statements of the management. *Id.* ¶ 22. The Tribunal cautioned, however, that "not all the provisions of these manuals, circulars, notes, and statements are included in the conditions of employment. Some of them have the character of simple statements of current policy or lay down certain practical or purely procedural methods of operation. It is, therefore, necessary to decide in each case whether the provision constitutes one of the conditions of employment. *Id.*

(c) Referral and Notification Requirements after *C v. IBRD*

*C. v. IRBD* produces an intricate, and often ill-defined, web of considerations for the World Bank's legal department regarding disclosure and notification related to criminal referrals. The legal department must work without knowing whether there is a blanket right to notify an employee of a criminal referral, regardless of the type of information referred. The lack of a definition for both "personnel" information and notice "as soon as reasonably possible" confounds the application of Staff Rule section 2.01, paragraph 5.01. For non-personnel information that falls outside of that rule, the World Bank must determine whether the Tribunal will feel that the referred information relates to accusations against the employee, despite the fact that the DOJ has not made any accusations. Furthermore, if the referral includes non-personnel information that is personal, the World Bank must determine whether an express or implied condition of non-disclosure exists and whether the referral will jeopardize the employee's defense before the DOJ, again without any accusations being made by the DOJ. The Tribunal must make all of these considerations under the shadow of an expensive potential monetary judgment.

The result of all of these considerations, in practical terms, is that the World Bank will now notify employees of all documents referred to the DOJ and may reconsider some referral decisions to avoid thorny questions, such as the existence of implied conditions of non-disclosure. This result is detrimental to the World Bank's overall anti-corruption strategy in two serious ways.

First, notification of referrals creates serious risks that the employee will obstruct the criminal investigation. In its pleadings, the Bank raised concerns that the Applicant "might attempt to destroy evidence, flee the jurisdiction, or harass and intimidate witnesses" once he is notified or granted access to investigative documents.[82] The Tribunal casts aside these concerns by stating that, in this case, the Applicant has cooperated with the World Bank and the DOJ, allaying any fears of obstruction by the Applicant.[83] The Tribunal's reasoning is based upon a naive assumption. The Applicant is required to cooperate with World Bank investigators under World Bank Staff Rules.[84] His carrying out his duties as an employee does not mean that he has refrained or will refrain from covering up his corrupt activity once he is notified that he has been referred to the DOJ. In fact, referral for criminal prosecution raises the possible harm an employee may face and may provide a greater incentive to an employee to cover up his activities. The Tribunal is simply in no position to know whether the Applicant has engaged or will engage in such obstructive activities, simply because he may have cooperated in the past.

Second, the complex disclosure and notification requirements imposed under *C v. IBRD* will probably result in the World Bank referring fewer documents to national prosecutors. This development will impact the effectiveness of criminal

82. *C v. IBRD*, Decision No. 272, at ¶ 24.

83. *Id.*

84. Staff Rules, *supra* note 15, § 8.01, ¶ 5.04 ("Staff members are required to cooperate in the investigation and failure or refusal to do so may constitute misconduct.").

prosecutions, by both limiting the scope and pace of criminal investigations. The result will be a reduction in the usefulness of criminal referrals as a punitive and deterrent tool for corruption within the World Bank and a weakening of the overall anti-corruption efforts of the World Bank.

2. Access to the Documents Referred

(a) Personnel Documents

The Tribunal also reads Staff Rule section 2.01, paragraph 5.01 to include a right to view the *contents* of the personnel information referred to criminal prosecutors.[85] It reads the rule to require the World Bank to give the Applicant the actual documents falling under this rule.[86] The Tribunal provides no legal reasoning for this conclusion. Instead, it is possible to interpret the rule narrowly as requiring a notification of only what information has been released, which might consist simply of a list of the documents referred, rather than copies of the documents themselves. Unfortunately, the Tribunal does not ponder the nuances of rule interpretation but rather decrees that the rule encompasses access to the documents themselves.

(b) Non-Personnel Documents — The Investigative Report

The component of the Tribunal's holding that will be the most detrimental to successful criminal referrals is the finding that the Applicant should receive copies of the World Bank investigative report referred to the DOJ.[87] The investigative report includes summaries of interviews with the Applicant and witnesses, investigator notes and other materials uncovered during the investigation.[88]

The Tribunal finds that the Applicant's access to the referred investigative report is "a matter that essentially is governed by principles of due process and fair treatment."[89] For the Tribunal, access to the investigative report is essential for the Applicant's right to respond to allegations against him. The principal authority the Tribunal cites is its previous decision, *King v. International Bank for Reconstruction and Development*.[90] The Tribunal writes:

> The Tribunal set out detailed standards for the handling of misconduct under Staff Rule 8.01 in *King*, Decision No. 131 [1993]. The Tribunal assigned particular importance to the conduct of the investigation, to the right of the accused staff

85. *C v. IBRD*, Decision No. 272, at ¶ 7

86. *Id.*

87. *Id.* It is important to be clear that the Tribunal found the referral of the investigative report permissible under the World Bank's Policy on Disclosure of Information. *See* Staff Rules, *supra* note 15, at § 2.01, ¶ 5.01. The Tribunal did not analyze the disclosure under World Bank Staff Rule section 2.01, paragraph 5.01, which applies to personnel information, assumedly because it did not consider the documents to constitute personal information, although the Tribunal did not explicitly say so.

88. *C v. IBRD*, Decision No. 272, at ¶ 16.

89. *Id.* ¶ 17

90. *Id.* ¶ 23

> member to respond, and to questions of due process. In respect of the right to respond, the Tribunal specifically held that "the entitlement of the staff member to respond presupposes an exact knowledge of the charge made against him and extends to the right to give a properly considered answer to, or comment upon, every aspect of the case made against him."[91]

The Tribunal was correct in finding that *King* established a "basic rule of due process that an accused person should be confronted with a specific charge and be given an opportunity to reply to it."[92] The *King* decision, however, dealt solely with an employee's due process rights in the context of allegations in *internal* disciplinary proceeding.[93] The Tribunal extends the due process protection in *King* to an entirely different context—the relationship between an employee and his national authorities in a prosecution against him.[94] The Tribunal's extension of an employee's due process rights to this context is flawed on numerous grounds.

Most importantly, the DOJ has not made any allegations against the Applicant. Once allegations are made, in the form of a grand jury indictment or information, the Applicant will have a chance to face his accuser, the United States government, and undertake discovery of prosecution documents and respond to any charges in a court of law without any "guesswork," a concern the Tribunal cites explicitly.[95] The Applicant's due process rights under the United States Constitution are protected from the moment his file is referred to the DOJ and he may petition the court with any procedural grievances he may have. Thus, his ability to defend himself against any allegation by the DOJ has not been impaired in any manner, a concern the Tribunal raises.[96]

Furthermore, like any other individual under investigation by the DOJ, the Applicant does not have a right to access the files and records in the possession of prosecutors prior to the start of formal criminal proceedings. In the U.S, and common law systems generally there simply is no right to know where you stand in the eyes of prosecutors while they investigate you, a privilege to which the Tribunal believes the Applicant is entitled.[97] Even in internal World Bank proceedings, under *King,* the employee does not have a right to information about his case until a formal allegation is made.[98] In civil law systems, a suspect's right to access investigative documents similarly attaches only once the formal investigative process has been launched by either the police or the public prosecutor, though the defendant may have access to files earlier than in common law systems.[99] Neither system compels a victim to turn over her documents or the

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91. *Id.* (quoting King v. Int'l Bank for Reconstruction and Dev., Decision No. 131, at ¶ 35 (World Bank Admin. Trib. 1993) [hereinafter *King v. IBRD*] ).

92. *King v. IBRD*, Decision No. 131, at ¶ 35.

93. *King v. IBRD*, Decision No. 131, at ¶¶ 29-82.

94. *See C v. IBRD*, Decision No. 272, at ¶¶ 3-35.

95. *C v. IBRD*, Decision No. 272, at ¶ 26.

96. *Id.* ¶ 32.

97. *Id.* ¶ 21.

98. *King v. IBRD*, Decision No. 131, at ¶¶ 33-37.

99. *See* Mario Chiavario, *Private Parties: The Rights of the Defendant and the Victim*, in EUROPEAN CRIMINAL PROCEDURES 541, 558 (Mireille Delmas-Marty and J.R. Spencer eds., 2002).

content of her communication with the police to the defendant. In both systems, the suspect's due process rights are only in relation to the national authority investigating him, not to the victim who refers him.

The Tribunal's decision in *C v IBRD* creates an unprecedented right of access to the DOJ investigation that is flawed on legal grounds under procedural rules of both common law and civil law systems. Prior to the Tribunal case, the Applicant was in no different position than any other individual under investigation by the DOJ. The Tribunal's holding, however, puts him in a privileged position as compared to all other individuals under the DOJ's jurisdiction. It alters the relationship between him and his member government to the detriment of the latter and is thus an illegitimate intrusion into the domestic legal process of a member government.

The Tribunal also reasons that "[s]trict enforcement of due process will also likely avoid accusations of a general nature unsupported by specific evidence that could mislead the national authorities."[100] This concern is allayed by the fact that government prosecutors are charged with the task of evaluating evidence for its veracity and integrity when constructing a case. If the facts of an investigative file contain speculative assertions, prosecutors can disregard such facts, or refrain from pursuing the prosecution. If unsubstantiated facts are introduced during trial, the criminal process allows the defense to produce contrary evidence and attack the veracity of any testifying witness.

The Tribunal also errs in its rationale for granting access to the documents by placing an inordinate degree of evidentiary weight to the investigative reports referred to the DOJ by the World Bank. The Tribunal raises alarm that "none of these documents bears the signature of the Applicant as evidence of his having admitted or accepted its conclusions."[101] The Tribunal ignores well-established rules of evidence in the U.S. denoting such summaries and notes as inadmissible hearsay [102] At trial, the court would require the World Bank investigator to testify about his interviews and would not allow the summaries themselves to be introduced as evidence. The procedural protections of the U.S. legal system make the Tribunal's protection unnecessary The result is only to impede the effective criminal investigation of the alleged corrupt activity

The *C v. IBRD* holding is further flawed on the grounds of fundamental policy considerations. Notification of criminal referral and access to referred documents raises the risk that an employee will engage in activities to obstruct the criminal investigation. As described earlier, the Tribunal is in no position to determine whether such obstruction has occurred or will occur based solely on the Applicant's prior cooperation, much of which was required by the World Bank's Staff Rules.

Even assuming the Applicant has not engaged in obstructive activity he may

100. *C v. IBRD*, Decision No. 272, at ¶ 26.

101. *Id.* ¶ 25.

102. FED. R. EVID. 801(c) (defining hearsay as "a statement, other than one made by the declarant while testifying at the trial or hearing, offered in evidence to prove the truth of the matter asserted.").

not know the full extent of the facts uncovered against him. With access to the investigative file, the employee could read witness interviews and see documents, which he may not have before known existed. His new knowledge could plausibly change his disposition with respect to cooperating. The Tribunal cannot know the risk of the Applicant destroying evidence, fleeing the jurisdiction or tampering with witnesses until the Applicant views the documents that have been referred to the DOJ. In this scenario, where an employee's level of cooperation could easily change, a bright-line rule barring access to such documents would ensure that employees who would want to obstruct the investigation would not have an opportunity to do so.

The Tribunal continues and states that "[n]or could the documents concerned be in any way destroyed or tampered with by the Applicant as they were already in the hands of the Bank and, later, of the Department of Justice."[103] The risk is not that the Applicant will destroy the specific files that have already been referred; rather, the risks are that other related evidence not yet subpoenaed will be destroyed, or the Applicant will tamper with witnesses before they are deposed by prosecutors or testify in the case. By ignoring the true risk involved in granting employees access to the investigative report, the Tribunal's rationale for allowing access to the documents is further flawed.

By saying that the facts of this case provide no specific risks, the Tribunal creates an ambiguous rule for the World Bank to follow in subsequent cases. Should the World Bank withhold its investigative report when it believes the person is a flight risk and expose itself to additional adverse judgments by the Tribunal if the Applicant does not flee? It is more likely that the Tribunal's holding will result in the World Bank turning over the investigative report to all subjects of referral in the future. This result is a disastrous policy as the real risks outlined above, ignored by the Tribunal in *C v. IBRD*, may be present in future cases and the effective subsequent prosecution of corruption may be seriously compromised.

Finally the Tribunal states that it has "reservations with respect to unnecessarily secretive procedures, which tend to result in unfair accusations and investigations."[104] Questioning the administrative procedures and judgments of divisions within the World Bank is a core component of the mandate of the Administrative Tribunal. The characterization of corruption investigations and subsequent criminal referral as "unnecessarily secretive, however, reveals a fundamental misunderstanding of the nature of effective anti-corruption efforts within organizations. Secrecy during an investigation and in the referral of information to prosecutors is essential to ensure that a suspect does not obstruct the investigation. There are sufficient due process guarantees already in place to ensure that such secrecy does not impose an unfair result upon a World Bank employee. Under *King*, the employee has a right to face his accuser in an internal

103. *C v. IBRD*, Decision No. 272, at ¶ 24.
104. *Id.* ¶ 26.

investigation.[105] Under the laws of his national jurisdiction, the employee has a right to face his national accuser in a court of law The Tribunal's reservations in this regard are both redundant and misguided and result in an unprecedented expansion of employee due process rights that guts the mechanism of criminal referral as an anti-corruption tool at the World Bank.

3. Addressing the Legal Obstacles of *C v. IBRD* and World Bank Rules

The explicit provisions of the Staff Rules and the Policy on Disclosure of Information impose limits on referrals while contemplating some form of employee notification.[106] The requirements specified in those provisions are expanded and complicated in the Tribunal's holding in *C v. IBRD*. In order to restore the World Bank's anti-corruption efforts, the procedures related to criminal referrals should be reformed. A new Staff Rule ought to be implemented allowing for the referral of any information, both personnel and non-personnel, to prosecutorial bodies in cases involving employee corruption, without notification and access.

Such a narrow provision would carve out a small area of full and unfettered disclosure for special cases involving corruption. Criminal referrals are different from disclosures to the general public and the due process and privacy rights of employees referred to the DOJ are protected under U.S. laws. Any remaining concerns about employee privacy should be outweighed by the World Bank's need for effective anti-corruption efforts, for which secrecy is essential. While staff opposition to such a new rule may be significant, the absence of such a provision will aid corrupt employees, who break the laws of the nations in which they work, in avoiding the most serious consequences for their actions.

## III. STANDARD OF PROOF CONCERNS IN INTERNAL CORRUPTION INVESTIGATIONS

The official standard of proof needed to be met to impose sanctions is evidence that is "reasonably sufficient to support a finding that the Respondent engaged in a fraudulent or corrupt practice "[107] The World Bank Tribunal has never announced the precise meaning of the "reasonably sufficient" standard.

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105. *Id.* ¶ 23; *King v. IBRD*, Decision No. 131, at ¶ 36.

106. *See* World Bank, The World Bank Policy on Disclosure of Information, June 2002, at § IV ¶ 89. In its discussion of the World Bank Policy on Disclosure, the Tribunal ignores one explicit constraint. "The individual records and personal medical information of Executive Directors and their Alternates and Advisors, of the President of the Bank, and of Bank staff, *as well as proceedings of internal appeal mechanisms and investigations, are not disclosed outside the Bank, except to the extent permitted by the Staff Rules*. *Id.* (emphasis added). While the Tribunal does not address whether the files referred in this case would qualify as "proceedings" of investigations, it is plausible that they could. Furthermore, the Tribunal ignores the Sanctions Committee Procedures which provide a blanket right of referral, contrary to the Policy of Disclosure and the holding of the current case. Thus, there is a need for an explicit Staff Rule provision allowing referral of all types of documents related to corruption investigations without notification to bring clarity to the legal regime for referral and to bolster the effectiveness of criminal referrals.

107 Sanctions Committee Procedures, *supra* note 18, at § 13.

While no standard is without some uncertainty, the World Bank's standard, standing alone, is devoid of any meaning without further definition of the clause "reasonably sufficient to support. The World Bank standard, as it currently stands, could require anything from evidence that establishes that the corrupt activity was more likely than not to have occurred (the common preponderance of the evidence standard) to evidence that establishes beyond a reasonable doubt that the corrupt activity occurred. A recent case raises serious concerns about the standard of proof applied in World Bank administrative proceedings involving corruption and fraud.

In September 2002, the High Court of Lesotho convicted Acres International, a prominent multinational engineering firm, of two criminal counts of corruption related to bribes paid to a senior government official in Lesotho for contracts related to an $8 billion water project, of which the World Bank contributed $150 million.[108] Prior to the criminal conviction, the World Bank's Fraud and Corruption Committee had conducted a two-year investigation into Acres and found insufficient evidence to justify debarment.[109]

This sequence of events, in which evidence against Acres clears the higher hurdle of reasonable doubt in a criminal proceeding in Lesotho, while failing to satisfy the presumably lower standard of proof in the World Bank, raises serious concerns about the efficacy of the World Bank's sanctioning mechanism. Before one discredits the World Bank's sanctioning mechanism, it is important to note that the Lesotho court, being a national criminal body, may have accessed evidence unavailable to World Bank internal investigators, given the lack of subpoena power of the World Bank.[110] Furthermore, the integrity of the criminal procedure in Lesotho should be further studied to ensure that the conviction was free from any political motivation or other impropriety. The World Bank, noting the conviction in Lesotho, formally reopened its investigation of Acres in March 2004.[111]

Despite these factors, however, the Acres case reveals a need for clarification of the "reasonably sufficient" standard in World Bank corruption proceedings. A standard roughly equivalent to the common "preponderance of the evidence" or "more likely than not" standard might be an appropriate approach. These standards, which are widely used in legal systems around the world in non-criminal matters, are regarded as balancing the interests of fairness to defendants with the interest of judicial expediency. If the current "reasonably sufficient" standard is higher than a preponderance of the evidence, lowering the standard

108. Michael Dynes, *Net Closes on Western Corruption in Africa*, TIMES (LONDON), Oct. 28, 2002, at 16.

109. Catherine Porter, *Oakville Engineering Company Braces for African Bribery Verdict*, TORONTO STAR, Sept. 12, 2002, at D01.

110. *See id.* Defense counsel for Acres argued that the evidence was identical to evidence presented at the World Bank internal proceeding. *Id.* Such claim should of course be taken with grain of salt, as it is clearly meant to imply that the defendant should be freed of all charges in the pending matter.

111. David Pallister, *World Bank Corruption Inquiry May Blacklist Firm*, GUARDIAN, Mar. 16, 2004, at 18.

could rid the Bank of corrupt agents, like Acres, in a more timely and effective manner while ensuring the fundamental fairness of the sanctioning system.

The World Bank could also follow the example of some U.S. government agencies that consider civil or criminal convictions against a contractor for certain related or unrelated offenses, such as theft or tax evasion, as sufficient evidence as a matter of law for debarment.[112] The World Bank could similarly regard debarment from government contracting systems in member governments as sufficient grounds to debar contractors from World Bank contracts. While these contractors would not have committed any fraud against the World Bank, a pattern of poor performance on prior contracts can be enough of a substantial risk to World Bank contracts as to require debarment.[113] Such an approach, however, might yield a far greater number of debarments of firms and individuals from Western countries that have more developed national government debarment systems. Such a result might prove to be a substantial political impediment to instituting such a system of debarment. The World Bank could impose shorter periods of debarment in cases such as these to compensate for the lack of a full investigation into firms. The Bank could also institute a system of suspensions, or short term freezing of funding, pending full investigation. Suspensions usually require a lower standard of proof, so that the initiation of criminal or civil proceedings for certain offenses can trigger a suspension.[114]

A further development that could dramatically reduce the time spent on investigations and more easily locate and eradicate corrupt activities is the implementation of an illicit enrichment provision in the World Bank's Sanctions Committee Procedures. Illicit enrichment provisions generally function by allowing prosecutors to introduce evidence of a government official's unexplained wealth or extravagant standard of living and to shift the burden to the person to prove a legitimate source for that wealth or standard of living.[115] A failure by the government official "to provide an adequate explanation would mean that the official must have traded on the governmental authority vested in him for personal gain."[116]

Illicit enrichment is most notably used in the successful anti-corruption efforts of Hong Kong.[117] Furthermore, all major multilateral conventions call for signatory

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112. *See e.g.*, Steven A. Shaw, *Suspension and Debarment: The First Line of Defense Against Contractor Fraud and Abuse*, REPORTER, Mar. 1999, at 4 (discussing suspension and debarment rules in the United States Air Force).

113. *Id.* at 5 (writing that the U.S. Air Force has wide latitude to debar firms for a history of unsatisfactory performance on private contracts, conduct that is neither criminal nor related to public contracts. The author points out, however, that agencies have failed to take advantage of such broad discretion).

114. *See id.* at 4.

115. Peter J. Henning, *Public Corruption: A Comparative Analysis of International Corruption Conventions and United States Law*, 18 ARIZ. J. INT'L & COMP LAW 793, 813 (2001).

116. *Id.* at 814.

117 Section 10(1) of the Hong Kong Prevention of Bribery Ordinance provides that:

(1) Any person who, being or having been prescribed officer, (a) maintains standard of living above that which is commensurate with his present or past official emoluments;

governments to establish illicit enrichment as a criminal offense.[118] Illicit enrichment is not a criminal offense in jurisdictions like the U.S. because it conflicts with a defendant's constitutional right to refrain from testifying against himself in a criminal matter.[119] However, the notion of illicit enrichment and burden-shifting to a defendant can be found in U.S. civil proceedings, including civil asset forfeiture actions related to criminal activity [120] Evidence that a person is living beyond his lifestyle can help build probable cause to support a civil forfeiture action which, when established, shifts the burden to the accused to prove, by a preponderance of the evidence, the legitimate source of the asset in question.[121]

Illicit enrichment provisions recognize the importance of integrity among public officials and understand both that unexplained wealth is a powerful indicator of impropriety among civil servants and that evidence of corruption is often hard to gather, a challenge that is even more acute in the case of the World Bank, given its lack of subpoena power.[122] Establishing illicit enrichment, without an adequate explanation by the official, as a sufficient ground to find against an employee for breaching his duties to the World Bank could offer a faster and more effective method of finding and expelling corrupt actors from the World Bank.

An illicit enrichment provision would not violate any established due process rights of World Bank employees. Employees do not have a privilege against self-incrimination in internal investigation proceedings. In fact, the World Bank staff is subject to an express duty to cooperate in internal investigations. World Bank Staff Rule section 8.01, paragraph 5.04, states that in internal investigations, "[s]taff members are required to cooperate in the investigation and failure or refusal to do so may constitute misconduct, which can serve as a ground for termination under the Staff Rules.[123] The World Bank also expressly allows

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> or (b) is in control of pecuniary resources or property disproportionate to his present or past official emoluments, shall, unless he gives a satisfactory explanation to the court as to how he was able to maintain such standard of living or how such pecuniary resources or property came under his control, be guilty of an offence.

Hong Kong Prevention of Bribery Ordinance, *available at* http://www.icac.org.hk/eng/prevt (last visited Jan. 30, 2002).

118. *See* Inter-American Convention, *supra* note 3, at art. IX (mandating that signatories "[s]ubject to its Constitution and the fundamental principles of its legal system, each State Party that has not yet done so shall take the necessary measures to establish under its laws as an offense a significant increase in the assets of government official that he cannot reasonably explain in relation to his lawful earnings during the performance of his functions. Among those States Parties that have established illicit enrichment as an offense, such offense shall be considered an act of corruption for the purposes of this Convention."). *See also* OECD Convention, *supra* note 2, at art. 1, 2; U.N. Convention, *supra* note 4, at art. 20.

119 U.S. CONST. amend. V

120. *See* United States v. Edwards, 885 F.2d 377 (7th Cir. 1989).

121. *See id.* at 390 (holding where "a defendant's verifiable income cannot possibly account for the level of wealth displayed and where there is strong evidence that the defendant is a drug trafficker, then there is probable cause to believe that the wealth is either direct product of the illicit activity or that it is traceable to the activity as proceeds.").

122. *See supra* note 110, and accompanying text.

123. Staff Rules, *supra* note 15, at §8.01, ¶5.04; *see also id.* § 0.01, Principle 7.1(b)(iv).

internal investigators to "[c]all upon any staff member for the production of documents believed to have probative value."[124] While the World Bank Tribunal has not addressed whether staff members have a privilege against self-incrimination during investigations, the express Staff Rules nowhere establish or suggest such a privilege, but rather enunciate the opposite—a duty to cooperate.[125] Given the lack of a self-incrimination privilege, the World Bank should proceed with an illicit enrichment provision that considers unexplained wealth or extravagant lifestyle, without adequate explanation, as sufficient to find staff misconduct. A guarantee that financial records would not be disclosed to third parties, other than criminal prosecutors in the case of corrupt activity, should be made to protect the privacy of staff members.

The World Bank should also consider widespread financial disclosure requirements for employees, covering all sources of income, to safeguard against conflicts of interest. Currently, less than fifty senior World Bank officials are subject to such disclosure.[126] Financial disclosure requirements for public officials are seen as an essential component to ensuring the integrity of public organizations. In the U.S., for example, detailed annual financial disclosures are required of members of all three branches of government.[127] Public officers of only the highest grade are usually required to file, though given each grade has ten steps, the total number of such officials across the federal government is significant.[128] A wider base of individuals subject to such disclosure would increase transparency and provide preliminary evidence under any illicit enrichment provision once enacted.[129]

## IV INVESTIGATIVE INFORMATION SHARING AND CROSS-DEBARMENT

Currently, the World Bank does not have investigative information sharing or cross-debarment agreements with other multilateral or bilateral development

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124. *Id.* §8.01, ¶5.04.

125. Providing employees with such a privilege would be contrary to the Staff Rules as well as detrimental to effective fact-finding and resolution of internal corruption investigations. Given the Tribunal's expansive view of employee due process, and the suspiciousness with which it views the World Bank's investigations, the World Bank may want to include an explicit provision, such as a staff rule, that enunciates the fact that employees do not have privilege against self-incrimination. Note that the issue of whether statements made by employees in a World Bank administrative proceeding can later be excluded in a subsequent prosecution in a national court has not been litigated.

126. Staff Rules, *supra* note 15, at § 3.01, ¶ 8.02 (noting only "[s]taff members at the level of vice president or above" are subject to the requirement); *see also* World Bank Group, Senior Management, at http://web.worldbank.org/ (last visited Feb. 6, 2004) (listing senior management positions).

127. *See generally* Ethics in Government Act of 1978, Pub. L. No. 95-521, 92 Stat. 1824 (1978).

128. *See e.g.*, 5 C.F.R. § 2634.202 (2003) (defining public filer for the purposes of executive branch disclosure requirements).

129. In summary, U.S. government disclosure rules measure the sources and value of income and do not require the disclosure of a public official's net worth. Ethics in Government Act, at §§102, 202, 302. Net worth evidence would have greater evidentiary value for World Bank investigators, in the event that an illicit enrichment provision is adopted. Any effort to implement such disclosure requirement, or any further disclosure requirements for that matter, would face significant political opposition from staff members.

finance institutions. Transnational corruption often involves repeat players who may practice in numerous developing countries and contract with different development banks. Sharing investigative information with other development finance institutions and instituting a system of cross-debarment can expedite the World Bank's corruption investigations and ensure that corrupt firms and individuals can not be debarred by one lender only to find another institution to defraud.

Substantial obstacles against implementing investigative information sharing and cross-debarment agreements with other institutions exist. The first is the lack of uniformity between different organizations in the quality of investigations and the standards of proof used. In April 2003, the Fourth Conference of Investigators of International and Bilateral Institutions convened in Brussels to address this concern.[130] Representatives from the World Bank and the United Nations presented a number of Uniform Guidelines for investigations, which were endorsed by representatives from international and bilateral institutions.[131] The guidelines include ethical principles for investigators, detailed procedural rules for investigating and administering inculpatory and exculpatory findings, policies on the confidentiality and protection of witnesses and the due process rights of subjects.[132] The Uniform Guidelines, however, are only aspirational principles to which institutions are not bound. A second obstacle is the risk of institutions debarring firms for political purposes. A bilateral institution may debar foreign firms more often than domestic firms or may target specific firms for political purposes, under the rouse of a corruption investigation.

The World Bank could sidestep these limitations by creating investigation information sharing and cross-debarment agreement only with institutions that conform to the uniform guidelines. Any agreement could also require institutions to open their respective investigation files for review by their partner institutions, in order to ensure that institutions are meeting the ethical and procedural requirements of the uniform guidelines. Furthermore, the World Bank could require additional evidence in cases in which it suspects that political motivations marred the referring institution's investigation, or it could exercise its discretion and not debar the firm. Given these suitable responses, an investigative information sharing and cross-debarment regime would be a viable approach for the World Bank to undertake to increase the effectiveness of its anti-corruption efforts.

130. *See* Press Release, European Anti-Fraud Office, The 4th Conference of International Investigators held in Brussels on 3rd and 4th April 2003 (Apr. 4, 2003), *available at* http://www.europa.eu.int/geninfo/info-en.htm (last visited Feb. 15, 2004).

131. *Id.*

132. Address before The 4th Conference of International Investigators (Apr. 2003) (on file with author).

## V STRUCTURAL CONSTRAINTS TO EFFECTIVE ANTI-CORRUPTION EFFORTS AT THE WORLD BANK

The World Bank's operational model, governance structure, oversight capacity, staff and contractor incentive structure, bureaucratic norms, political motivations and the status of the internal investigate body all pose additional obstacles to the control of corruption within the World Bank. This section addresses the problems arising when structural attributes of the Bank impede effective anti-corruption efforts or even create incentives contrary to the goal of curbing corruption at the World Bank.

### *A. The World Bank s Operational Model*

Under the World Bank Articles of Agreement, the World Bank is authorized only to lend to governments and to third parties when the loan is guaranteed by the government in which the party is located.[133] Governments in developing countries are responsible for the execution of projects and are given a large degree of discretion to carry out projects.[134] Government agencies charged with implementing projects are responsible for procuring firms and contractors for projects and managing and disbursing the loan funds.[135]

Structurally, this operational model exposes the World Bank to significant corruption risk. Developing country governments are plagued with weak procurement systems, insufficient supervisory personnel for projects, inadequate resources for investigating and prosecuting corruption and poor legal rules and procedures to prevent, detect, and address corruption.[136] For example, in a recently approved $46 million World Bank urban revitalization loan to Brazil,[137] the World Bank noted that the coordinating agency in charge of overseeing the entire project, FIDEM, "has the minimum structure necessary to undertake a project of this type,

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133. IBRD Articles of Agreement, *supra* note 54, at art. III § 4, *available at* http://www.web.worldbank,org/ (last visited Feb. 6, 2004) ("The Bank may guarantee, participate in, or make loans to any member or any political sub-division thereof and any business, industrial, and agricultural enterprise in the territories of member, subject to the following conditions: (i) When the member in whose territories the project is located is not itself the borrower, the member or the central bank or some comparable agency of the member which is acceptable to the Bank, fully guarantees the repayment of the principal and the payment of interest and other charges on the loan.").

134. While World Bank loan documents are not publicly disclosed, World Bank Project Appraisal Documents offer detailed descriptions of World Bank financed projects. Generally, the borrower government manages the majority of the project with assistance from a World Bank Task Manager and World Bank consultants. Project Appraisal Documents and other documents can be accessed on-line at: http://www-wds.worldbank.org/ navigation.jsp? pcont=browdoc (last visited Feb. 6, 2004).

135. *See e.g.*, WORLD BANK, PROJECT APPRAISAL DOCUMENT ON A PROPOSED LOAN IN THE AMOUNT OF US$46.0 MILLION TO THE STATE OF PERNAMBUCO, BRAZIL WITH THE GUARANTEE OF THE FEDERAL REPUBLIC OF BRAZIL FOR THE RECIFE URBAN UPGRADING PROJECT, REP NO. 23331-BR (Apr. 2003) (listing specific government responsibilities related to a recently approved $46 million World Bank urban revitalization loan to Brazil) [hereinafter PROJECT APPRAISAL DOCUMENT].

136. GAO REPORT, *supra* note 20, at 16.

137 World Bank, *World Bank Approves $46 Million For Low-Income Urban Upgrading In Northeast Brazil*, Apr. 24, 2003.

but that structure is generally weak, understaffed and not entirely prepared to address the complexities involved in a large, inter-institutional and governmental project of this size."[138] Public procurement and financial systems in these countries may also be inadequate to ensure the integrity of the transactions. The appraisal document of the same urban revitalization loan to Brazil, for example, noted that FIDEM's "[o]verall procurement capacity is considered weak and the risk for the project is considered high."[139]

In addition, the World Bank's institutional mission to eradicate poverty[140] involves it in lending to the poorest countries in the world, which also tend to be the most corrupt.[141] The World Bank is also often called upon to lend to countries emerging from conflict situations where the institutional structures are often too weak to ensure the integrity of the funds lent to them.[142] In these situations, in which countries do not have adequate institutional "absorption capacity" to handle aid, lending can actually provide an incentive for governments to create poor governance structures so that aid money can be diverted for illegitimate uses.[143]

The World Bank is also a bank in the traditional sense of the word and its success is measured by traditional measures of banking success such as the rate of return of its projects, which depends on the number of loans it makes and its rate of default.[144] These measures ensure that the World Bank retains its superb credit rating, as the "IBRD raises almost all its money in the world's financial markets" where "[w]ith a AAA credit rating, it issues bonds to raise money and then passes on the low interest rates to its borrowers."[145] The pressure to make loans, and especially large loans, creates a "culture of loan approval," characterized by a pattern of overly optimistic and misguided lending that leads to a deterioration in

138. PROJECT APPRAISAL DOCUMENT, *supra* note 136, at 35.

139. *Id.* at 37.

140. The World Bank's Mission Statement begins with "[o]ur dream is a world free of poverty" and continues "[t]o fight poverty with passion and professionalism for lasting results. World Bank Group, About Us, Mission Statement, *at* http://www.worldbank.org/ (last visited Feb. 6, 2004).

141. At the time of this writing, the World Bank has active projects in all of the ten most corrupt countries according to the *2002 Transparency International Corruption Perceptions Index*. The countries from least corrupt to most corrupt are: Moldova, Uganda, Azerbaijan, Indonesia, Kenya, Angola, Madagascar, Paraguay, Nigeria, and Bangladesh. 2002 Transparency International Corruption Perceptions Index, *available at* http://www.transparency.org/pressreleases_archive/2002/dwld/cpi2002.presrelease.en.pdf (last visited Feb. 15, 2004).

142. Glenn T Ware & Gregory P Noone, *The Culture of Corruption in the Postconflict and Developing World*, *in* IMAGINE COEXISTENCE: RESTORING HUMANITY AFTER ETHNIC VIOLENT CONFLICT 191, 194 (Antonia Chayes & Martha Minow eds., 2003). *See also* Paul Blustein, *G-7 Agrees That Iraq Needs Help With Debt; Important Roles Seen For IMF World Bank*, WASH. POST, Apr. 13, 2003, at A37

143. *See* Glenn T. Ware & Gregory P Noone, *supra* note 142, at 197 (discussing examples of corrupt governmental schemes that may occur in the developing country and post-conflict contexts).

144. *See* World Bank, About Us, What is the World Bank, *at* http://www.worldbank.org/ (last visited Feb. 15, 2004). The World Bank explicitly disagrees with this observation and describes itself as "[n]ot bank, but rather a specialized agency. The World Bank is not 'bank' in the common sense. It is one of the United Nations' specialized agencies, and is made up of 184 member countries. These countries are jointly responsible for how the institution is financed and how its money is spent. *Id.*

145. *Id.*

the quality of loans made and exposes them to corruption.[146]

> [P]ressure to lend encourages Bank operations staff to identify their interests with those of their clients in the recipient government. Task managers, who typically operate in one sector, develop working relationships with government officials in the relevant ministries. These officials, who implement projects under the supervision of the task manager, are also responsible—or are closely connected to the people responsible—for the approval of the next proposed Bank project for the sector. Given that the task manager wants the project and the government needs the loan, it does not take long for an understanding to develop in which problems associated with existing projects are overlooked in exchange for a smooth path for new projects in the pipeline.[147]

Furthermore, if "lending [declines], the Bank will shrink in size and become a less central player in the international economy."[148]

The World Bank itself first described this phenomenon in an internal 1992 report known as the *Wapenhans Report*, named after the World Bank Vice President who directed the study producing the report.[149] The report found that this culture of loan approval could be characterized by overly optimistic project appraisal ratings, poor identification of risk factors, and inconsistent and subjective evaluation criteria across projects that had resulted in over one-third of completed Bank projects qualifying as failures under the Bank's own evaluation criteria.[150]

The *Wapenhans Report* pointed towards gross corruption, finding that seventy-eight percent of the financial conditions in World Bank loans were not adhered to, a statistic that the report considered "startlingly low."[151] In subsequent years, numerous reports of widespread corruption in World Bank financed projects have surfaced. In 1997 for example, *Business Week* alleged that over $100 million of a $500 million World Bank loan to the Russian coal sector either could not be accounted for or had been diverted.[152] At the time of the story, the World Bank was

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146. Bruce Rich, *The World Bank Under James Wolfensohn*, *in* REINVENTING THE WORLD BANK 26, 43 (Jonathan R. Pincus & Jeffrey A. Winters eds., 2002). *See also* HOWARD N. WHITE & A. GESKE DIJKSTRA, PROGRAMME AID AND DEVELOPMENT: BEYOND CONDITIONALITY 489 (2003) ("aid agencies exist to give away money, and there is an ample literature documenting that individual and agency performance are assessed on the quantity of aid rather than its quality"). *See also* MICHELLE MILLER ADAMS, THE WORLD BANK: NEW AGENDAS IN A CHANGING WORLD 5 (1999) ("Most staff members believe the 'approval culture' is still in place"); PAUL J. NELSON, THE WORLD BANK AND NON-GOVERNMENTAL ORGANIZATIONS: THE LIMITS OF APOLITICAL DEVELOPMENT 89 (1995) ("The institutional tendency to define success in terms of money moved is in keeping with the tendency in official development circles to assess the adequacy of the industrial world's aid efforts by reference to the amounts of money or per centages of GNP devoted to the cause.")

147. Jonathan R. Pincus, *State Simplification and Institution Building in Development Project*, *in* REINVENTING THE WORLD BANK, at 76, 98 (Jonathan R. Pincus & Jeffrey A. Winters eds., 2002).

148. ADAMS, *supra* note 146, at 18.

149. World Bank, Portfolio Management Task Force Report Findings (1992), *available at* http://www.worldbank.org/html/opr/pmi/maintxt5.html (last visited Feb. 14, 2004).

150. *Id.*

151. *Id.*

152. Carol Matlack, *What Happened to the Coal Miners Dollars? At Least $100 Million from a World Bank Loan is Lost*, BUS. WK., Sept. 8, 1997, at 52.

preparing a new $500 million loan for the Russian coal sector, and *Business Week* observed that "World Bank officials seem surprisingly unperturbed by the misspending. They contend offering loans to spur change is better than micromanaging expenditures."[153]

While the risk of default should logically provide a counter-incentive to an overzealous "culture of lending, the risk of default is nearly inexistent in the case of World Bank loans. All World Bank loans are guaranteed by governments, which reduces the risk of loss for the loan to nearly zero,[154] as history shows that developing countries governments rarely default on World Bank loans.[155] The reasons for this phenomenon vary by country, but include the high levels of dependence upon development assistance common in some countries, the weight private lenders place on a country's good standing with the World Bank, the lower interest rates and longer repayment terms countries can get from the World Bank *vis-a-vis* private lenders, and the lack of access to the international capital markets of many countries due to a below investment grade credit rating. With the risk of default minimized to nearly zero, any significant risk to World Bank lending decisions is removed, and a "culture of loan approval" is free to thrive, exposing World Bank funds to higher risks of corruption.[156]

### *B. The World Bank s Governance Structure*

The World Bank's governance structure may also contribute to the "culture of loan approval" and the lack of critical attention given to projects. The World Bank is owned by Member governments who provide paid-in and callable capital in exchange for ownership shares in the Bank.[157] Member governments benefit from

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153. *Id.*

154. Allan H. Meltzer, et. al, *Report of the International Financial Institution Advisory Commission* (2000), *available at* http://www.house.gov/jec/imf/meltzer.htm (last visited Feb. 12, 2004) ("the host government guarantee, required by all Bank lending, eliminates any link between project failure and the Bank's risk of loss"). In 1998, the U.S. Congress set up the International Financial Institutions Advisory Commission, chaired by Allan Meltzer and including prominent economists, business people and politicians, to review the usefulness of number of international financial institutions. *Id.* The commission released the report in March 2000. *Id.*

155. *See* ADAMS, *supra* note 146, at 19 (noting that "[o]ver the years, a normative consensus has formed among lending institutions and borrowing countries alike that treating the World Bank as a preferred creditor is a central part of playing by the rules of international finance.").

156. One commentator cautions against viewing the World Bank as "simply money-pushing institution. *See* Devesh Kapur, *The Changing Anatomy of Governance at the World Bank*, *in* REINVENTING THE WORLD BANK, at 54, 71. Professor Kapur notes that the Bank's lending has leveled off in the 1990s, except for limited bail out lending. *Id.* However, according to its annual report, the IBRD increased its new lending by one billion dollars in fiscal year 2002. ANNUAL REPORT, *supra* note 8, at 26. The flattening in the 1990s may be more attributable to a global economic downturn beginning in 1999 rather than the absence of an overzealous "culture of lending. It is also possible that allegations of widespread corruption and irresponsible lending have applied pressure upon the Bank to reduce its lending. Professor Kapur also notes that any money-pushing by the World Bank is dwarfed by private sector lending to developing countries and that more attention should be placed on the much larger unregulated system of international capital flows rather than the relatively small scale activity of the World Bank. Kapur, *supra* note 146 at 71.

157 IBRD Articles of Agreement, *supra* note 54, at art. II.

the business and sales generated by Bank projects and place pressure on the Bank staff to approve more and bigger loans.[158] For example, the U.S. share in procurement and contracting volume combined from the World Bank is twenty-one percent.[159] Governments and creditors within member countries may also push for new loans so that developing countries can continue to service their debt.[160] These interests provide little incentive to reign in new loans and projects. Member governments also lack the incentive to criticize the activities of other Member governments, lest they cast a light upon their own practices.

### C. *Lack of and Limits to Project Oversight for Corruption*

In addition to an incentive structure that promotes overly optimistic lending, the World Bank lacks the ability to oversee all of its projects to ensure the integrity of project funds. The World Bank requires borrowers and project implementation entities to provide the Bank with annual independently audited financial statements.[161] An investigation into World Bank management by the U.S. General Accounting Office (GAO) in the year 2000 found that

> [t]he Bank is required to approve the selection of the auditors. However, Bank guidance on auditor selection acknowledges that it is often not possible to ensure the independence of auditors, particularly government auditors that are used for auditing Bank-financed projects in many countries. The Bank guidance states that government auditors are frequently not professionally qualified accountants—many are political appointees, and some are public service administrators. Furthermore, the Bank has been concerned that government auditing institutions sometimes are understaffed, underfinanced, and subject to political pressure.[162]

In addition, audits are limited in their ability to reveal core issues of fraud and corruption, in that business records upon which financial statements are based may be fraudulent and left uninvestigated.[163]

The scale of lending activity that the World Bank undertakes and its geographical dispersion across the globe can create a trade-off between effective oversight and efficiency Supervision missions to all project sites are implausible due to cost and time constraints. The IBRD and IDA generate about 40,000 individual procurement contracts annually, of which 10,000 (60 percent of value) undergo prior review by Bank staff.[164] The remaining 30,000 are subject to

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158. Winters, *supra* note 9, at 122.

159 MICHAEL D.V DAVIES, THE ADMINISTRATION OF INTERNATIONAL ORGANIZATIONS: TOP DOWN AND BOTTOM UP 355 (2002).

160. BERTIN MARTENS ET AL., THE INSTITUTIONAL ECONOMICS OF FOREIGN AID 4 (2002).

161. PROGRESS SINCE 1997, *supra* note 7, at 8.

162. GAO REPORT, *supra* note 20, at 16.

163. Winters, *supra* note 9, at 116 (citing a task manager who states, "The auditors themselves—and I've talked to a number of them—they admit freely that all they do is look at the books. If the books balance, they say 'we've looked at it according to international auditing standards, and we find that the records are in order. But the records themselves could be fraudulent. Auditors will tell you it's not their job.")

164. WORLD BANK, HELPING COUNTRIES COMBAT CORRUPTION: THE ROLE OF THE WORLD BANK

selective "post-audit" review,[165] which is rarely carried out.[166] Even in cases of prior review, without a complaint about the procurement contract under review, it is very difficult to find evidence of a kickback or bribe payment from the contract itself.[167]

The 2000 GAO report also found that loan appraisal documents remained unduly optimistic. The report found that a

> review of 12 projects approved after November 1998 confirmed that the Bank's senior decision makers still have not adequately assessed the risks posed by potential corruption and weak managerial capacity of borrowers Only 4 of the 12 projects we reviewed identified corruption or undue political interference as a critical project risk (even as a low or negligible one), even though Bank reports had indicated that corruption is a problem in all of the countries included in our project sample.[168]

Review of a randomly selected recent loan appraisal document showed that the Bank seems to have made minor progress in its review of corruption.[169] The appraisal repeatedly noted the high levels of risk in procurement and financial management as well as political risk.[170] Corruption risk was not specifically addressed as a risk factor but was eluded to once in the appraisal, finding that an external audit had been conducted on the main implementing agency and had reported no misuse of the preliminary funds for the research and development of the project.[171] The Bank should consider creating a distinct component in loan appraisal documents for corruption risk assessment, as they currently do for social and environmental impact.[172] Corruption risk should also be included in the sensitivity analysis of the project's cost-benefit calculation, as it directly impacts the financial outcomes of a project.

The clear inability to oversee all of its projects requires the World Bank to be especially vigilant in its termination of corrupt employees and in its debarment of firms. The World Bank's oversight regime has been compared to the self-reporting tax regime of the Internal Revenue Service.[173] In such systems, probity may only be achieved when the consequences of being caught for fraudulent conduct are serious enough to outweigh the low probability of being caught.[174] Stronger and swifter sanctions in internal corruption proceedings, including criminal convictions of corrupt actors, and a larger number of debarments and terminations are necessary to achieve this outcome in World Bank projects. The

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34 n.27 (1997).

165. *Id.*

166. Winters, *supra* note 9, at 119.

167. *See id.* at 119-20.

168. GAO REPORT, *supra* note 20, at 19-20.

169. *See* PROJECT APPRAISAL DOCUMENT, *supra* note 135.

170. *Id.*

171. PROJECT APPRAISAL DOCUMENT, *supra* note 135, at 96.

172. *Id.*

173. Winters, *supra* note 9, at 119.

174. *See id.* at 119-20.

World Bank must also disseminate information of its successes in anti-corruption proceedings more effectively to provide notice to governments and corrupt actors that the penalties for corruption are severe and mounting. The recent criminal convictions of two former World Bank employees, for example, were not publicly disclosed by the World Bank, so any deterrent value that their convictions may have had on other corrupt actors was lost.

### *D. Staff Incentives and Organizational Structure*

The incentive system and the organizational structure under which World Bank staff operates may often oppose the aims of effective corruption control. Like any bank officer, staff members have an interest in generating new and larger loans to further their professional prominence within the organization.[175] Due to the difficulty in measuring the impact of loans, evaluation of staff within aid agencies often concentrates more on the number of loans made.[176] Staff members also cultivate personal relationships with country representatives and may feel pressure not to offend them or the Member government they represent.[177] The desire of country representatives to secure new loans combined with the staff member's incentive to generate loans can sacrifice critical analysis of lending decisions for corruption and other risks.[178] Rotation of staff can be used to break personal connections and reduce corruption risk. The World Bank could consider such a system, though it might involve a significant trade-off between anti-corruption effectiveness and professional expertise, as regional or sector experts are moved to new regions and sectors.

### *E. Sentiments Regarding Project Corruption and Development*

Another obstacle to effective anti-corruption efforts is a norm voiced by some staff members that a project with corruption is a lesser evil than no project at all.[179] By this logic, the people of a developing country are better served by a school construction project with a fifty percent corruption rate, in which 500 out of the required 1000 schools are built, than with no project that results in zero schools.

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175. NELSON, *supra* note 146, at 90 ("Careers at the World Bank have long been built primarily by designing projects that win Board approval. It is commonplace in insider discussions that staff advance primarily by identifying, designing, negotiating and preparing projects that the Board will approve and that further the investment program in country.").

176. ADAMS, *supra* note 146, at 5 ("In the development field where the criteria for success are so long-term and uncertain, lending volume was one of the ways in which the Bank could be judged as having an impact. As a result, the Bank's organizational culture puts premium on concluding loans, especially large loans, and staff members have been evaluated and promoted on their success in doing so"); *see also* MARTENS ET AL., *supra* note 160, at 4.

177 Marcus W Brauchli, *Speak No Evil: Why the World Bank Failed to Anticipate Indonesia Deep Crisis*, WALL ST. J., July 14, 1998, at A1 ("World Bank officials knew corruption in bank-funded projects was common, but never commissioned any broad reports tracking how much money was lost to it, in part, some bank officials say, because they feared having to confront the government."). *See also* Rich, *supra* note 146, at 43 (citing World Bank internal report noting "fear of offending the client".)

178. Pincus, *supra* note 147.

179. Winters, *supra* note 9, at 120.

One senior World Bank official is quoted as saying, "[i]f you take the amount of 30 percent loss it means 70 cents [on the dollar] got used for development after all."[180]

While logically persuasive, this proposition has been attacked as shortsighted and naively optimistic. A task manager is cited as retorting:

> .[M]y experience has been—and it's the experience of a lot of other people there [on the operations side of the Bank]—if they're busy stealing 30 percent, they're not paying any real attention to the other 70, even assuming 30 percent is all they're taking. What you're really doing is really ruining the whole effectiveness of the investment itself If you let out a contract for $2 million, and you get the few civil servants at the top sharing $600,000 or 30 percent, do they care if the contractor puts in concrete that is just sand and water? Do they care if the contractor doesn't put reinforcing steel in the structures? They don't care. So when Bank people say we're at least getting 70 cents of good development on the dollar, no you don't. Because the contractor either has to make back the money that he's kicked back, or he just figures, "hey it's open season, I do what I want and no one is going to challenge me. And so you have this feeding frenzy, and the end result is you get very little development.[181]

Furthermore, the notion that projects with corruption can be a "second-best" to clean projects ignores the long-term phenomena of escalating corruption. In an escalating corruption scenario, corrupt government officials who safely divert half of an initial contract are emboldened to divert larger shares of subsequent contracts until the project is reduced to simply a transfer of funds to the corrupt official, with no project component at all.[182]

This norm of overlooking corruption may be most prevalent when a nation is experiencing rapid growth or undergoing social and economic transformations of which the World Bank approves. In the case of Indonesia, for example, World Bank oversight was lacking because "the World Bank considered this sprawling archipelago's rise from poverty its great triumph."[183] In early 1998, World Bank President James Wolfensohn admitted that "[w]e were caught up in the enthusiasm of Indonesia I am not alone in thinking that 12 months ago, Indonesia was on a very good path."[184] The World Bank Indonesia country head spoke of "a trade-off between, shall we say being pure and helping people We have to decide every morning when we wake up, are we doing more good than harm?"[185] But when that same country head visited a dozen villages looking at schools built with World Bank funding, "[a]ll were crumbling only months after their completion, the evident result of massive corruption that resulted in use of substandard

180. *Id.* at 111 (citing an interview with Katherine Marshall and Julian Schweitzer at World Bank Headquarters in Washington D.C. on April 10, 1999).

181. *Id.* at 120.

182. *Id.* at 111, 120.

183. Brauchli, *supra* note 177

184. *Id.*

185. *Id.*

materials,"[186] confirming the critique offered above that development usually does not occur in such corrupt projects.[187]

The incidence of this norm among World Bank staff members is difficult to measure. While one can assume that most staff members are committed to the goals of anti-corruption, one cannot simply assume that most staff members would support wholly canceling many development projects because of corruption. Any tolerance of corruption based on this notion of a "second-best" remains an obstacle to effective corruption-fighting in the World Bank.

### *F Political Considerations in Lending*

Political and foreign policy considerations often shape the lending decisions of the World Bank and lead to an overlooking of corruption risk. Throughout its history, the lending decisions of the World Bank have often followed the political and foreign policy aims of its largest shareholder, the United States. These external considerations explain the World Bank's decisions not to lend to Vietnam in the 1970s and 1980s, not to lend to Iran in the 1980s and 1990s, and to reduce lending to India and Pakistan after their nuclear tests in 1998.[188] During the Cold War, political allies of the U.S., including Indonesia, Turkey Mexico, Congo, and the Philippines continually received World Bank funding despite widespread corruption, repeated noncompliance with loan provisions, and political instability.[189] Most recently, the World Bank provided funding to reconstruction efforts in Afghanistan and is now being looked upon for funding in the Iraqi reconstruction effort, despite the lack of any reliable civil authorities in either locale.[190] These reconstruction efforts are also current cornerstones in American foreign policy efforts. The link between World Bank lending and political and foreign policy objectives of leading shareholders will continue to pose a risk to the integrity of World Bank loan funds.

All of these factors help explain why the World Bank has been reluctant to make long-term commitments to cut off funding for countries in the face of evidence of widespread corruption or of a generally corrupt business environment. The case of Kenya provides an illustrative example. In 1997 the World Bank suspended a $72 million dollar loan to Kenya, together with an IMF suspension of $220 million in loans, in the face of endemic corruption.[191] Despite the clear

186. *Id.*

187. Winters, *supra* note 9, at 111, 120.

188. Kapur, *supra* note 156, at 59-60.

189. Jonathan R. Pincus & Jeffrey A. Winters, *Reinventing the World Bank*, *in* REINVENTING THE WORLD BANK, at 1, 5-6 (citing Catherine Gwin, *U.S. Relations with the World Bank, 1945-1992*, *in* 2 THE WORLD BANK: ITS FIRST HALF CENTURY 195, 252-63 (Kapur et al. eds., 1997)).

190. World Bank, *New World Bank Grants Worth US $90 Million Reach Out Across Afghanistan*, June 6, 2002, *at* http://web.worldbank.org/· World Bank, *World Bank Supports International Reconstruction Fund Facility for Iraq*, Oct. 22, 2003, *at* http://web.worldbank.org/

191. Pamphil Kweyuh, *Kenya-Economy: World Bank Stops US$71.6 Energy Project*, INTER PRESS SERVICE, Aug. 13, 1997. *See also* Thomas Omestad, et al., *Bye-bye to Bribes: The Industrial World Takes Aim at Official Corruption*, U.S. NEWS AND WORLD REP Dec. 22, 1997, at 39.

failure of Daniel Arap Moi's administration to tackle corruption in Kenya—it made a number of public and administrative gestures—the World Bank resumed lending shortly thereafter, only to suspend loans again in December 2000.[192]

Only a month after a new president, Mwai Kibaki, took office in December 2002 pledging to curb corruption, the World Bank announced it would again resume lending as early as July 2003 if the government implemented measures demanded by IMF donors.[193] The Kenyan government launched a serious public effort to combat corruption, creating an anti-corruption commission and a new Ministry of Justice and Constitutional Affairs, appointing the head of Transparency International in Kenya to a senior governmental position overseeing public ethics and integrity forcing the resignation of the notoriously corrupt former Chief Justice, and requiring that all public officials disclose their wealth—with the President being the first to do so.[194]

The World Bank, however, did not require an actual reduction in the level of corruption nor did it conduct any assessments of changes in corruption levels or risk since the inauguration of the Kibaki government. The outcome of the current prosecution of the chief project director involved in the Kenyan road scandal that led to the U.S. convictions of two World Bank employees last year is still pending.[195] The Kibaki administration has not made any progress on World Bank demands that other top officials and contractors involved in that scandal be prosecuted and banned from future government tenders.[196] Kenyan Attorney General Amos Wako even cautioned recently that "the culture of corruption is deeply rooted and efforts to stop it might become entangled in political wrangling."[197] If the political will of the Kibaki government to fight corruption withers or runs into any major obstacles, the World Bank could find itself suspending lending for a third time.

The Kenyan government has also made promising developmental reforms in its first one-hundred days, beyond its anti-corruption reforms, by introducing universal free primary education, launching a scheme to restructure the financial system to benefit the agricultural backbone of the Kenyan economy building up strategic grain reserves to forestall food shortages, and passing a number of anti-crime measures that have reduced the crime rate in half across the country [198] For the World Bank, any risk of corruption seems to be outweighed by the need to support the developmental goals of the administration. The Kenyan case reveals that the notion of tolerating corruption risk when the broader development policies or practices of the country are favorable to the World Bank is still present.

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192. *See* Gus Selassie, *World Bank to Resume Development Assistance to Kenya*, WORLD MARKETS RES. CENTRE DAILY ANALYSIS, Jan. 30, 2003.

193. *Id.*

194. *U.S. Diplomat Highlights Kenya Actions Against Corruption and Terrorism*, ALL AFR., Sept. 13, 2003; *Kibaki, Cabinet Declare Wealth*, ALL AFR., Sept. 30, 2003.

195. Kevin Kelley, *Two Swedes Jailed over Bribes in Kenyan Deal*, ALL AFR., Feb. 6, 2004.

196. *Corruption Watch World Bank Kenya Counter Attacks*, AFR. ANALYSIS, May 8, 2002.

197. Press Releases and Documents, Voice of America, Kenya/Corruption (July 24, 2003).

198. Yu Xinchao, *Opportunities, Challenges Coexist in Reconstruction of Kenya*, XINHUA NEWS AGENCY, Apr. 14, 2003.

### G. *Incentives for Firms and Contractors*

Firms and contractors who are hired by the World Bank or by governments to participate in World Bank financed projects can lack the proper incentives to report corruption to the World Bank. The World Bank currently does not have a provision that allows internal investigators to offer immunity to firms who assist in corruption investigations. So, a firm that has paid bribes to a government official in a World Bank financed project faces debarment if it comes forward with

allegations against the government official. If the firm has not engaged in corrupt activity but is aware of corruption, it may still not come forward out of a fear of losing future World Bank or government contracts. The creation of an anonymous hotline to report corrupt activity may mitigate the risk to whistleblower firms and contractors, but may not provide enough protection in the minds of some contractors to overcome the fear of retaliation in the bidding process for future projects.

### H. *The Status of the Internal Investigative Body*

Another serious structural problem threatening the World Bank's anti-corruption efforts is the precarious status of the internal investigative body within the World Bank bureaucracy [199] In bureaucratic structures, internal investigations bodies tend to be viewed with reservations if not outright distrust. The World Bank Tribunal in *C v. IBRD* implied such a suspicion when it wrote that the internal investigative body performed in an "unnecessarily secretive" manner that violated the due process rights of employees.[200] The Tribunal has found due process defects in a number of other investigations.[201] These cases affirm the fears of some staff members that the work of the internal investigations department oversteps its authority and illegitimately intrudes into their employment relationship with the Bank. The fact that the Department of Institutional Integrity is an independent body accountable only to the President of the Bank heightens the distrust some within the Bank feel towards it.

The creation of an internal investigations body for the World Bank follows from the World Bank's Articles of Agreement, which includes a provision stating, "the Bank shall make arrangements to ensure that the proceeds of any loan are used only for the purposes for which the loan was granted."[202] The World Bank has

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199. GAO REPORT, *supra* note 20, at 12 (observing that the Investigations Unit did not have the necessary stature within the World Bank).

200. *See C v. IBRD*, Decision No. 272, at ¶ 26 (World Bank Admin. Trib. 2002).

201. *See* Koudogbo v. Int'l Bank for Reconstruction and Dev., Decision No. 246, at ¶¶ 14, 43 (World Bank Admin. Trib. 2001). *See also* Dambita v. Int'l Bank for Reconstruction and Dev., Decision No. 243, at ¶¶ 26, 28 (World Bank Admin. Trib. 2001); Cisse v. Int'l Bank for Reconstruction and Dev., Decision No. 242, at ¶¶ 37, 43 (World Bank Admin. Trib. 2001). It is important to note that these decisions were decided when the internal investigative process was fragmented, prior to the creation of unified Department of Institutional Integrity. This new structure allegedly increases the Bank's system of checks and balances over the procedures of the internal investigations unit.

202. IBRD Articles of Agreement, *supra* note 54, at art. III § 5.

not formally established the Department of Institutional Integrity with an Executive Board order, as the United Nations has done with its internal investigations body through United Nations General Assembly resolution 48/218.[203] Approving a World Bank Executive Board order would bolster the organizational legitimacy of the investigations unit and would also establish the office permanently, removing any threat to its continued operation.

### *1. Recommendations for Addressing Structural Obstacles*

A number of recommendations have already been offered in this paper to address some of the structural obstacles detailed above. These include issuing an Executive Board order formally establishing the World Bank's internal anti-corruption unit, providing the option of immunity from debarment to firms who come forward with allegations of corruption, rotating project staff more frequently, publicizing criminal referrals and other punitive measures against corrupt firms and individuals more widely to bolster the deterrence value of such activities, analyzing corruption risk as a distinct component in project appraisals and including corruption risk in the sensitivity analysis of the cost-benefit calculations of proposed projects.

Recommendations to address the serious challenges of the World Bank's operational model and governance have also been widely offered in the public domain. Some have recommended that the World Bank dramatically reduce its level of lending "until the quality of administration and supervision in projects, both on the Bank's part and on the borrower's side, is improved to a degree that the resources are not squandered."[204]

The *Meltzer Commission Report* draws a starker conclusion, calling for the elimination of all lending to countries with investment grade credit ratings.[205] The Commission recommends that loans to poor countries without access to capital markets should still be made but for institutional reform and that developmental aid should be aimed at public goods like health care and should be administered through performance based grants rather than loans.[206] The Meltzer Commission included some prominent dissenting members who attacked the Commission's recommendations as potentially threatening the fight against global poverty.[207] They questioned the Commission s recommendation to limit the nonconcessional lending of the IDA branch of the World Bank, which extends interest-free loans to

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203. *See* G.A. Res. 48/218B, U.N. GAOR, 48th Sess., 87th mtg., U.N. Doc. A/RES/48/218, at art. II, ¶9 (1994).

204. Winters, *supra* note 9, at 122-23 (Winters finds task managers who agree with him, such as one who concludes: "We're long way from turning the corner on the Bank's culture. There will not be real progress until there's genuine slowing down of the lending program.")

205. Meltzer, *supra* note 154.

206. *Id.*

207. *Id.* (dissenting statement of C. Fred Bergsten, Director, Institute for International Economics; Richard Huber, Former Chairman, President, and CEO, Aetna, Inc., Jerome Levinson, Former General Counsel, Inter-American Development Bank; and Esteban Torres, U.S. House of Representatives, 1983-99).

the poorest countries of the world.[208] They also questioned the commitment of Western governments to fund a grant-giving agency after the lending capital of the World Bank is returned to Western governments per the Commission's recommendations.[209] Finally, they feared the impact on developing countries of being forced to rely on international capital markets, which may be volatile.[210]

The World Bank had already undertaken one of the Meltzer Commission proposals, by aggressively pursuing capacity-building in developing countries to create the type of procurement, managerial and legal institutions necessary to ensure the integrity of its funds.[211] The *Overview of World Bank Activities in Fiscal 2002* noted that "[p]ublic administration was by far the leading sector for IBRD lending, receiving $3.6 billion, over 30 percent of the total. The significant amount of lending in the public administration sector reflects the Bank's focus on assisting its clients to improve development strategies, implement reform policies, and build institutional capacities."[212]

The movement towards institutional reform should proceed with caution. In the past, the use of economic aid as a tool for policy reforms has been mixed in its success and is a controversial and contentious topic.[213] In addition, the World Bank has espoused dramatically different patterns of thinking in the realm of institutional development over the past thirty years that should cast doubt on its knowledge base in governance reforms.[214] Furthermore, there is no accepted institutional formula for reducing corruption within countries and the tremendous variation between countries requires customized and local political solutions.[215] For these reasons, the World Bank should foster greater policy dialogue within

208. *Id.*

209. *Id.*

210. *Id.*

211. PROGRESS SINCE 1997, *supra* note 7, at 44.

212. World Bank, Overview of World Bank Activities in Fiscal 2002, *at* http://www.worldbank.org/ annualreport/2002/Overview.htm (last visited Feb. 8, 2004).

213. WHITE & DIJKSTRA, *supra* note 146, at 518 (for detailed analysis of the history and controversies related to aid conditionality with case studies of conditionality programs). *See also* WORLD BANK, ASSESSING AID 4 (1998) (The World Bank's own analysis of policy-based aid shows "that donor financing with strong conditionality but without strong domestic leadership and political support has generally failed to produce lasting change.").

214. *See* ADAMS, *supra* note 146, at 108 (describing the World Bank's view on state involvement in economic development as swinging pendulum over the past four decades). *See also* WHITE & DIJKSTRA, *supra* note 146, at 518.

215. *See generally* Mushtaq H. Khan, *Corruption and Governance in Early Capitalism: World Bank Strategies and Their Limitations*, *in* REINVENTING THE WORLD BANK, *supra* note 146, at 164, 181-83 (proposing that the World Bank's anti-corruption prescriptions are founded on misguided assumption that reducing the discretionary role of the State will promote growth. Instead, the historical evidence attests to the fact that all developed nations have undergone a period during which State intervention supported the interests of an emergent capitalist class at the expense of other classes. What separates the underdeveloped from the developed is that in the latter, the State had the political capacity to reign in the capitalist class to ensure that preferential disparate treatment did not become oriented towards the capture of State resources. The key, then, is not to "right-size" underdeveloped States with reforms that reduce their discretion, but to allow discretion and preferential treatment while supporting political reforms to ensure that political leadership can control the emergent capitalist class once it begins to thrive.)

developing countries about the power structures that foster and maintain corruption and how to diffuse power so that citizens may more easily hold their governments accountable for corruption.[216] For this reason, any anti-corruption governance reforms should be devised in collaboration with civil society and the population at large in developing countries.

A reasonable compromise between the viewpoints in the current debate on fundamental World Bank reform may be a viable avenue to follow The Bank has not sufficiently addressed concerns about its culture of overly optimistic lending decisions. A recent $46 million urban revitalization loan to Brazil attests to the continuing culture of lending optimism at the World Bank.[217] The loan appraisal document identified an overall project risk rating of "substantial."[218] The appraisal rated the risk associated with the project's implementing agency as "high, noting "[w]eak management and technical capacity of the executing [agencies' coordination of the project] (FIDEM and Municipalities), particularly in the areas of procurement and financial management."[219] The loan appraisal did mention risk mitigation strategies which included hiring numerous technical consultants to assist the implementing agency and numerous World Bank supervisory visits.[220] In spite of these measures, the World Bank should reconsider lending to projects with "substantial" overall risk ratings in which the primary weaknesses is in the main implementing agency Reducing lending to such risky projects might not necessarily produce an overall reduction in World Bank lending, as funding for safer projects and anti-corruption reform might be increased.

In the interim, as the World Bank addresses these larger institutional questions, it should ensure that its own internal investigations unit is properly financed and trained and has the proper legal framework within which to function. This framework would include the reforms related to the recent *C v. IBRD* opinion discussed above, the enactment of an illicit enrichment provision, a clear and effective standard of proof, and the ability to share information with other agencies and cross-debar. Increased public recognition of their efforts and an Executive Board order formally recognizing their existence as a mandated institution under the Bank's Articles of Agreement will also help to promote the stature of the internal investigations unit while increasing the deterrent value of their work. The internal investigative bodies should also provide training to national prosecutors in developing countries to help prosecute corrupt firms and individuals the World

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216. Some critics argue that the Bank's technical solutions to corruption overlook the power arrangements in all corrupt client countries that allow certain actors in society to flout formal rules for their personal benefit. Winters, *supra* note 9, at 113. The Bank itself admitted in its 1997 anti-corruption Framework that, "[i]n some countries the primary reason for divergence [from formal rules] may be political, a manifestation of the way power is exercised and retained. This limits what the Bank can do to help outside the framework of its projects. PROGRESS SINCE 1997, *supra* note 7 at 13.

217 World Bank, *World Bank Approves $46 Million for Low-Income Urban Upgrading in Northeast Brazil*, Apr. 24, 2003, *at* http://web.worldbank.org/.

218. The possible risk ratings were "high, "substantial, "modest, and "negligible or low. PROJECT APPRAISAL DOCUMENT, *supra* note 135, at 50-51.

219. *Id.* at 51.

220. *See generally id.*

Bank refers to them. Funding and training should also be provided to investigators and prosecutors in developing countries to help build corruption cases related to World Bank loans.

## V CONCLUSION

In the face of a wealth of research on the debilitating effects of corruption in developing countries and mounting evidence of endemic corruption in World Bank projects, the World Bank announced an institutional commitment to curbing corruption in its projects in 1996.[221] Since then, the World Bank has launched a multi-pronged strategy to attempt to ensure the integrity of the projects it finances throughout the developing world. Nearly a decade later, the World Bank's anti-corruption efforts are continuing to develop in concert with a growing international effort to curb corruption. However, serious legal and structural uncertainties and obstacles stand in the way of full effectiveness of the World Bank's efforts. Expansive due process rights of employees in criminal referrals, an uncertain standard of proof in internal corruption investigations, no system of investigative cooperation and cross-debarment, and a series of fundamental structural impediments pose significant threats to the success of the World Bank's anti-corruption efforts. Substantive reforms ranging from a new Staff Rule ensuring secrecy during criminal referrals to the formal calculation of corruption risk in loan appraisal documents offer realistic ways to strengthen the anti-corruption efforts of the World Bank. Unless these necessary internal legal and structural reforms are undertaken, the integrity of all World Bank projects will be uncertain at best, imperiling the future of the broader global development project itself.

221. World Bank, News, Issue Briefs, Corruption, *at* http://web.worldbank.org/ (last visited Feb. 8, 2004).

# THE TRIAL OF SLOBODAN MILOSEVIC: THE DEMISE OF HEAD OF STATE IMMUNITY AND THE SPECTER OF VICTOR'S JUSTICE

*Scott Grosscup*

The conflict in Yugoslavia during the last decade has culminated in unprecedented events in international law due to circumstances particular to the region. The war exposed a number of the intense ethnic tensions between Bosnian, Croatian, and Serb populations[1] that had lain dormant in the Balkan region for many years under the rule of General Josip Broz Tito. [2] The fall of the Soviet Empire in the late 1980's and early 1990's, and the rise of right to self-determination principles in the region during the same period,[3] brought instability and war to Europe, the likes of which had not been seen since the end of World War II. The resulting ethnic hatred and political instability led an international force to bring peace to the region[4] and has seen the first instance where the leader of an independent state is on trial for crimes that occurred while he was in power.[5]

The events that began in Yugoslavia in the early 1990's are not over. However, the majority of the violence that accompanied the rise and fall of Slobodan Milosevic has subsided.[6] The conflict involved numerous states and international organizations.[7] After ten years, United Nations troops are still

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1. *See generally* JOSEPH ROTHSCHILD, RETURN TO DIVERSITY, A POLITICAL HISTORY OF EAST CENTRAL EUROPE SINCE WORLD WAR II 260-262 (Oxford University Press 1993).

2. *See* GARY JONATHAN BASS, STAY THE HAND OF VENGEANCE 209 (Princeton University Press 2000) (estimating that Josp Broz Tito and his communist partisans executed between 20,000 and 40,000 of the opposition Ustasha fascists in Tito's rise to power, mostly through summary executions, for fear that criminal trials would enrage ethnic tensions).

3. *See generally* ROTHSCHILD, *supra* note 1.

4. *See* Roger Cohen, *Crisis in the Balkans*, NY TIMES, June 15, 1999, at A1 (quoting a United Nations mediator,0 Carl Bildt, "An international military presence to guarantee peace in the Balkans must be seen in the coming decades").

5. Sheema Khan, Comment, *Welcome Ex-Dictators, Torturers and Tyrants: Comparative Approaches to Handling Ex-Dictators and Past Human Rights Abuses*, 37 GONZ. L. REV 167 194 (2002) (comparing state actions against ex-dictators involved in human rights violations and the role of the International Criminal Court in bringing ex-dictators to justice).

6. *See generally* U.S. Department of State, *Background Note: Serbia and Montenegro, available at* http://www.state.gov/r/pa/ei/bgn/5388.htm (last visited Feb. 27, 2004).

7 In addition to the United Nations and NATO forces, the Red Cross, Amnesty International and numerous other organizations have provided assistance and aid to the redeveloping nations. *See Bosnia Help Organizations, available at* http://www.cco.caltech.edu/~bosnia/help/org.html (last visited Feb. 27, 2004) (listing of some of these agencies).

deployed in the region,[8] serving to keep the peace, and numerous non-governmental organizations (NGOs) are on the ground, administering aide, overseeing relocation programs, and ensuring safe transitions to democracy.[9]

The conflict in Yugoslavia has also forged new ground on how the international community deals with a nation's internal conflicts.[10] This includes international intervention by a regional peacekeeping force[11] and, in particular, the first trial of a sitting head of state for state sanctioned criminal activities, and violations of the evolving area of human rights law.[12]

This paper will examine the trial of Slobodan Milosevic, former President of Serbia and the Federal Republic of Yugoslavia. Part I discusses the events that led to the arrest and charges against Milosevic. Part II explores why traditional notions of sovereign immunity have not applied to his trial. Part III examines the reasons why the international community has made an effort to prosecute the former president. Lastly, Part IV looks at the impacts the trial will have on the former Yugoslavian states,[13] and potential ramifications if the prosecution fails to convict the former president.

## PART I — TURMOIL IN THE BALKANS: THE RISE AND FALL OF MILOSEVIC

Prior to the eruption of war in 1991, Yugoslavia was the "Darling of the West."[14] During this period, Yugoslavia received most-favored-nation status, technology transfers, and cultural exchanges.[15] However, the Balkan states[16] have complex ethnic and religious characteristics that have fueled conflict between the

8. *See generally* UNITED NATIONS MISSION IN BOSNIA AND HERZEGOVINA, *available at* http://www.un.org/Depts/DPKO/Missions/unmibh/unmibh_body.htm (last visited Nov. 30, 2002); *see also* UNITED NATIONS INTERIM ADMINISTRATION MISSION IN KOSOVO, *available at* http://www.unmikonline.org/ (last visited Nov. 30, 2002).

9. A search of the Regional Environmental Center found 127 environmentally focused non-governmental organizations operating in Bosnia-Herzegovina, 150 in Croatia and 160 in Yugoslavia. *Available at* http://www.rec.org/REC/Databases/NGODirectory/NGOFind.html (last visited Nov. 22, 2002).

10. There is some debate as to whether the conflict in the former Yugoslavia constitutes an international or an internal conflict. The International Criminal Tribunal for the Former Yugoslavia (ICTY), for purposes of jurisdiction, has decided that the war in Yugoslavia was of international character.

11. *See generally* NATO Fact Sheet, NATO's role in Bosnia and Herzegovina, *available at* http://www.nato.int/docu/facts/2000/role-bih.htm.

12. *See, e.g.*, Richard B. Bilder, *Kosovo and the "New Interventionism Promise or Peril?* 9 J. TRANSNAT'L L. & POL'Y 153 (1999) (exploring the doctrine of humanitarian intervention in Kosovo).

13. The former Yugoslavia was composed of six republics, Slovenia, Croatia, Bosnia-Herzegovina, Serbia (with the once autonomous regions of Vojvodina and Kosovo), Montenegro, and Macedonia.

14. JOHN FEFFER, SHOCK WAVES EASTERN EUROPE AFTER THE REVOLUTIONS 254 (South End Press 1992).

15. *Id.*

16. The Balkans states are located between the Adriatic Sea to the west and the Black Sea on the East, with Turkey and Greece to the South, and Slovakia and Ukraine to the North. SATELLITE WORLD ATLAS 78-79 (Helicon Publishing 2001) (1999).

Bosnian, Serb, and Croatian populations.[17] The assassination of Austrian Archduke Ferdinand by a Bosnian Serb nationalist in 1914 was the spark that sent the modern world into what was at that point the worst war in history [18] After World War I, the Balkan states formed the state of Yugoslavia in 1929 [19] This union of ethnic Serb, Croat, and Slovene populations was tenuous, and in 1934 a member of the Croatian independence movement assassinated King Alexander of Yugoslavia.[20] Yugoslavia once again saw an invasion, but this time by the Axis powers of Germany and Italy in World War II.[21] During the War, Croatian collaborators worked to rid Croatia of Serbs, mimicking the Nazi concentration camps and exterminating over 500,000 Serbs and displacing another million.[22] Communist partisan forces, led by Josip Broz Tito and assisted by the Allied powers, helped rid the territories of Axis occupation.[23] From 1945 until Tito's death in 1980, ethnic tensions and nationalistic movements were suppressed by the state through relocating Serb minorities in the various republics outside of Serbia.[24] Professor Michael Scharf notes, "Tito's death and the collapse of the Soviet threat in the late 1980's unleashed the long-festering centrifugal forces that would soon lead to Yugoslavia's disintegration."[25]

The next section explores the recent history of the conflict in the former Yugoslavia, the creation of the International Criminal Tribunal for the Former Yugoslavia (ICTY), and events leading to the arrest and indictment of Slobodan Milosevic as potential precedent necessary for the international community to respond to conflict and serving as the base line for international law and the demise of heads of state immunity

*1 History of the conflict*

Slobodan Milosevic was born in Pozarevac, Serbia in 1941 to a communist activist mother and absent father.[26] Milosevic excelled at the University Law School in the 1960's.[27] After earning his law degree, Milosevic held several Communist Party positions in city government and was appointed president of the largest state-run bank in 1978.[28] In 1986, Milosevic was appointed Communist

17. *See* MICHAEL P SCHARF & WILLIAM A. SCHABAS, SLOBODAN MILOSEVIC ON TRIAL 14 (The Continuum International Publishing Group, Inc. 2002) (citing commentators who date the beginnings of the turmoil in the Balkans to 1389 when the Ottoman Turks defeated Serbian forces in the battle of Kosovo Polje, starting several hundred years of occupation by the Ottoman Empire).

18. *See id.* at 15. The assassination occurred on the anniversary of the battle of Kosovo Polje which occurred 525 years earlier.

19. *Id.* at 15-16.

20. *Id.* at 16.

21. *Id.*

22. *Id.*

23. *Id.* at 17.

24. *Id.* at 17

25. *Id.* at 18.

26. *Id.* at 5 (noting that both parents eventually committed suicide).

27. *Id.*

28. *Id.* at 8.

Party leader after his friend and close ally, Ivan Stambolic, became President of Serbia.[29] That same year the Serb Academy of Arts and Sciences published a memorandum that became the manifesto of the Serb nationalist movement and led to Milosevic's rise to power.[30] While Communist Party leader, Milosevic was sent to Kosovo to quiet a Serb uprising against the Albanian majority.[31] Milosevic spoke to a crowd of Kosovar Serbs and said:

> No one has the right to beat our people! This is your land, these are your homes, these are your fields, your gardens, and your memories Would you shame your ancestors and disappoint your children? We will win this battle. Yugoslavia does not exist without Kosovo Yugoslavia and Serbia will not give it away.[32]

Milosevic used these nationalistic emotions, suppressed by the Tito regime for years, to become President of Serbia in 1989 just as anti-Serb nationalism rose in the republics of Croatia and Slovenia.[33]

In June 1991, at the order of President Milosevic, the Yugoslav National Army invaded Slovenia and Croatia under the guise of "protecting" Serbs living in those republics from anti-Serb sentiments.[34] In a brutal military campaign, the Serbs quickly gained control over nearly one-third of the Republic of Croatia.[35] United Nations investigators later found mass graves in numerous places including outside the city of Vukovar, where Serb forces massacred over 200 Croatian hospital patients.[36]

Citing the rising tide of war in the region, the United Nations Security Council adopted Resolution 713 in September 1991, which imposed an embargo on the sale of arms to areas within the territory of Yugoslavia and called for the parties to abide by the ceasefire agreement they had signed just a few days earlier in Igalo.[37] By February 1992, satisfied that the conditions had been met for the deployment of peace-keeping operation to the region, the United Nations Security Council adopted Resolution 743, establishing the United Nations Protection Force (UNPROFOR).[38] Subsequently, the Republic of Bosnia and Herzegovina voted for independence from Yugoslavia on March 1, 1992,[39] which was recognized by the European Community on April 6, 1992.[40] Shortly after the dissolution of

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29. *Id.* at 9.
30. *Id.* at 9-10.
31. *Id.* at 10.
32. *Id.*
33. *See id.* at 11. The leaders of Croatia, Franjo Tudjman, and Slovenia, Milan Kucan, sought to dilute Serbian influence in Yugoslavia by creating a loose federation of states, leading to the dissolution of Yugoslavia in 1991. *Id.* at 19.
34. *Id.* at 19-20.
35. *Id.* at 20.
36. *Id.*
37 S.C. Res. 713, U.N. SCOR, 3009th mtg., U.N. Doc. S/Res/713 (1991).
38. S.C. Res. 743, U.N. SCOR, 3055th mtg., U.N. Doc. S/Res/743 (1992).
39 SCHARF, *supra* note 18, at 22.
40. STEVE TERRETT, THE DISSOLUTION OF YUGOSLAVIA AND THE BADINTER ARBITRATION

Yugoslavia, Serb forces attacked Croatian and Bosnian Muslim populations in the republic of Bosnia and Herzegovina to unite Bosnian Serb populations with greater Serbia.[41] Although the official Yugoslav National Army (JNA) eventually pulled out of Bosnia and Herzegovina, Serbia continued to arm and direct Bosnian Serbs in the self-declared "Republika Srpska, a Serb-dominated area of BiH,[42] over the next few years committing violations of international humanitarian law,[43] numerous mass killings,[44] and attacks on United Nations designated "safe areas."[45] The United Nations's inability to provide security for these areas led civilians to call their "guests" by the derogatory name, "UNprotection Force, from the acronym UNPROFOR, or United Nations Protection Force.[46] One of the worst massacres of the war occurred in eastern Bosnia in the town of Srebrenica after Bosnian-Serb troops overran United Nations peacekeeping forces and then executed thousands of unarmed men and boys alongside trenches.[47]

In 1995, after air strikes carried out by the United States with NATO support, Slobodan Milosevic traveled to the United States and signed the Dayton Peace Accord dividing Bosnia and Herzegovina into two "entities:" the Bosnian-Serb "Republika Srpska" and the Muslim-Croat Federation.[48] The accord also allowed for greater deployment of United Nations Peacekeeping forces known as IFOR. [49] After several years of war, and up to 250,000 Muslim deaths and the displacement

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COMMISSION: A CONTEXTUAL STUDY OF PEACE-MAKING EFFORTS IN THE POST COLD WAR WORLD 33 (Ashgate Publishing Co. 2000).

41. SCHARF, *supra* note 18, at 22. Bosnian Serb forces led by Radovan Karadzic seized control of nearly seventy-percent of Bosnia leaving several enclaves under Bosnian control—Sarajevo, Mostar, Bihac, Tusla, Srebrenia, and Gorazde.

42. NORMAN CIGAR & PAUL WILLIAMS, INDICTMENT AT THE HAGUE: THE MILOŠOVIC REGIME AND CRIMES OF THE BALKAN WAR 25 (New York University Press 2002); TERRET, *supra* note 41, at 33.

43. *Final Report of the Commission of Experts Established Pursuant to Security Council Resolution 789 (*1992), U.N. SCOR, 49th Sess., at Part IV U.N. Doc S/1994/674 (1994), *available at:* http://webmedia2.depaul.edu/ihrli/publications/yugoslavia.asp. *See also* Prosecutor v. Dusko Tadic, Judgment of the Appeals Chamber, IT-94-1-A (1999). Dusko Tadic was the first war criminal to be tried by the International Criminal Tribunal for the former Yugoslavia. Tadic was convicted of individual criminal responsibility of willful killing; torture or inhuman treatment; willfully causing great suffering or serious injury to body or health; crimes against humanity and violations of customs of war all in violation of the 1949 Geneva Convention. Tadic was present at the Omarska, Keraterm, and Trnopolje camps in the Republic of Bosnia where he participated in "horrendous treatment" upon non-Serb populations including the forced transfer of civilians to camps, beatings, and killings of those civilians. Tadic was sentenced to twenty years in a German prison for violations of international humanitarian law.

44. *Id.* at 61.

45. *See* SCHARF, *supra* note 18, at 26-27 United Nations forces were deployed to protect and demilitarize the six "safe areas" with a force of 7,500.

46. *See, e.g.*, Emma Daly, *Croats Dismiss Fears Of New War* Independent (London), Jan. 23, 1995, at 8.

47 YVES BEIGBEDER, JUDGING WAR CRIMINALS 149 (St. Matin's Press, Inc., 1999) (describing the July 11, 1995 Serb attack on the U.N. safe haven of Srebrenica, in which over 40,000 people, mostly Bosnian Muslims, fled the area and anywhere from 4,000 to 10,000 men and boys were systematically killed).

48. TERRET, *supra* note 41, at 96.

49. SCHARF, *supra* note 18, at 30-31.

of over 2 million from Serb-controlled areas in Bosnia and Herzegovina,[50] it appeared that violence in the region had reached its maximum and peace was on the horizon.[51]

Ideas of self-determination permeated the region, however, and, in 1996, the Kosovo Liberation Army (KLA) began attacking Serbian positions.[52] Serbian forces then turned their energies away from Bosnia and Herzegovina and began clearing ethnic Albanians from the territory of Kosovo through forced relocation and killings of civilians.[53] The ensuing exodus of the ethnic Kosovo Albanians brought about another NATO bombing campaign,[54] the withdrawal of Serb forces from the region, and a new government in Serbia.[55]

The NATO led bombing campaign, economic crisis, international pressure, and years of unrest evaporated Milosevic's grasp on power. In September 2000, Vojislav Kostunica defeated Milosevic in the Federal Republic of Yugoslavia's presidential elections.[56] Milosevic did not recognize the results of the election even though the Constitutional Court of Yugoslavia and the Serbian Parliament recognized Kostunica as the legitimate president.[57] Milosevic finally submitted his resignation on October 6, 2000, after Serb soldiers along with thousands of protesters stormed government buildings ending his tenure as president.[58] As a result of the change in leadership, the United States lifted the oil embargo and flight ban that had been imposed on the region since 1998.[59] At the same time, leaders with the International Monetary Fund (IMF) announced plans to readmit Yugoslavia,[60] which had lost membership in the international financial institution in 1992.[61] IMF membership enabled access to significant financial support for the tattered country's redevelopment.

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50. *Id.* at 35.

51. Raymond Bonner, *Bosnian Civilians Hopes for Peace Are Modest*, N.Y TIMES, Dec. 20, 1995, at A10.

52. 52.SCHARF, *supra* note 18, at 33.

53. Serb forces conducted killings of civilians as well as ethnic cleansing through rapes of Albanian women with the intent of impregnating them with Serbian children. *See generally* Todd A Salzman, *Rape Camps as a means of Ethnic Cleansing: Religious, Cultural and Ethical Responses to Rape Victims in the Former Yugoslavia*, 20 HUM. RTS. Q. 348, 363 (1998) (estimating anywhere from 20,000 to 70,000 survivors of rape from Serbian forces).

54. *Id.* at 34. NATO, using primarily the United States Air Force, bombed Serb forces from March 24, 1999 through June 9, 1999.

55. Steven Erlanger, *Showdown in Yugoslavia*, N.Y TIMES, Oct. 7, 2000, at A1.

56. SCHARF, *supra* note 18, at 36.

57. Erlanger, *supra* note 52.

58. SCHARF, *supra* note 18, at 36.

59. Lawrence L. Knutson, *U.S. Lifts Yugoslavia Sanctions*, AP ONLINE, Oct. 12, 2000, *available at* 2000 WL 27905642 (citing commentators who have noted that these sanctions were not in place during the war that dissolved the former Socialist Federal Republic of Yugoslavia from 1991 through 1995, discussed above, which experienced far greater casualties than the events in Kosovo).

60. *Id.*

61. *Id.*

*2. Creation of the ICTY*

The United Nations Security Council, pursuant to Article 39 of the United Nations Charter,[62] established the International Criminal Tribunal for the Former Yugoslavia (ICTY) on May 25, 1993.[63] Resolution 827 creating the ICTY states that the "situation [in Yugoslavia] continues to constitute a threat to international peace and security" and that the "establishment of an international tribunal and the prosecution of persons responsible for serious violations of international humanitarian law would contribute to the restoration and maintenance of peace."[64] The ICTY was designed to help restore peace in the region by serving internationally recognized views of justice, including the right to a fair trial.[65] The ICTY is composed of sixteen permanent judges from different states,[66] seven of whom serve in an appeals chamber where five judges sit on any individual appeal.[67] The ICTY Statute also creates the Office of the Prosecutor who is responsible for investigating and prosecuting persons accountable for "violations of international humanitarian law committed in the territory of the former Yugoslavia since January 1, 1991."[68] The prosecutor is ultimately responsible for determining whom to charge.[69]

The creation of the ICTY is not the first time that a special international tribunal has been created by an international organization for prosecuting war criminals.[70] However, its creation and potential success or failure does come at a significant time in history when countries of the world are working to define the scope and power of the International Criminal Court (ICC) created by the Rome Statute in 1998.[71]

In order to understand the ICTY it is important to first understand the court's primary predecessor, the Nuremberg International Military Tribunal. Although not

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62. U.N. CHARTER art. 39, states: "The Security Council shall determine the existence of any threat to the peace, breach of the peace, or act of aggression and shall make recommendations, or decide what measures shall be taken in accordance with Articles 4 and 42, to maintain or restore international peace and security.

63. *Security Council Resolution on Establishing an International Tribunal for the Prosecution of Persons Responsible for Serious Violations of International Law and Humanitarian law Committed in the Territory of the Former Yugoslavia*, S.C. Res. 827, U.N. SCOR, 84th Sess., 3217th mtg., U.N. Doc. S/Res/827, 1993.

64. *Id.*

65. *See id., see also* AMENDED STATUTE OF THE INTERNATIONAL TRIBUNAL ART. 21, *available at* http://www.un.org/icty/basic/statut/stat2000.htm.

66. *See id.* at art. 12, para. 1.

67. *Id.* at para. 3.

68. *Id.* at art. 16, paras. 1, 3.

69. *See id.* at art. 18, paras. 1, 4.

70. *See* BASS, *supra* note 3, at 5 (documenting six times when states have dealt with issues of international justice prior to the creation of the ICTY these include trials of the Bonapartists in 1815 after the 100 Days War; trials of German war criminals after World War I; prosecution of Turk perpetrators of the Armenian genocide; the Nuremberg trials of Nazi war criminals; the trial of Japanese war criminals in Tokyo; the current ex-Yugoslavia tribunal; and the trial for crimes that occurred in the genocide in Rwanda).

71. *See Final Report of the Commission of Experts, supra* note 44, at part IV

the first international court, the Nuremberg Tribunal serves as a significant example for how high-level politicians and senior military officers were put on trial for their part in crimes against humanity, war crimes, and crimes against peace.[72] The Nuremberg Tribunal, however, only judged the participation of Nazi officials during World War II.[73] As such, the tribunal has been labeled as a sort of "victors' justice, where the nationality of the judges and prosecutors were the same as those who won the war.[74] In fact, the Nuremberg Tribunal was created several months after the end of the war in Europe by an agreement of the United States, French, British, and Soviet representatives and did not include input from others in the international community.[75] The fledgling United Nations, created in June 1945 could have provided the opportunity for international input in establishing the Nuremberg Tribunal,[76] but it was bypassed by the victorious nations.[77]

The Nuremberg Tribunal also established general principles of criminal responsibility for individual state actors during wartime activities for international law.[78] This principle was later adopted by the United Nations General Assembly as Resolution 95 (1).[79] This movement away from actions between states to actions by states against individuals is a significant change in how the international community is willing to prosecute individuals acting during times of war. Perhaps, the world was appalled after learning about the acts of the Nazi's during the war and sought some relief through what seemed to be a more humane and proper treatment after all the bloodshed. Nonetheless, the Allied forces ran what some have called "kangaroo courts" to prosecute those that had been vanquished[80]

The Nuremberg Tribunal did not have the opportunity to try the major leaders of the Nazi regime due to the fact that individuals such as Adolf Hitler, and several

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72. BEIGBEDER, *supra* note 44, at 27.

73. *Id.* at 39 (stating that many modern scholars accept that activities undertaken by the Allied forces, including fire-bombing of German cities and the dropping of the atomic bombs on Hiroshima and Nagasaki, would constitute war crimes defined as "wanton destruction of cities, towns or villages, or devastation not justified by military necessity").

74. *Id.* at 39.

75. *See Agreement for the Prosecution and Punishment of the Major War Criminals of the European Axis, and Charter of the International Military Tribunal*, Aug. 8, 1945, pmbl., 59 Stat. 1544, 82 U.N.T.S. 279, 284 (charter) [hereinafter *Nuremberg Agreement and Tribunal*] (in which the governments of the United Kingdom of Great Britain and Northern Ireland, the United States of America, the provisional government of the French Republic and the Union of Soviet Socialist Republics declared they were "acting in the interests of all the United Nations" in concluding their agreement on how to prosecute German officials).

76. The United Nations Charter entered into force on October 24, 1945, while the International Military Tribunal was signed and entered into force on August 8, 1945. *See* U.N. Charter, *supra* note 59; *Nuremberg Agreement and Tribunal, supra* note 72.

77. *See Nuremberg Agreement and Tribunal, supra* note 72.

78. U.N. Charter, *supra* note 59, at art. 6.

79. *See Affirmation of the Principles of International Law Recognized by the Charter of Nuremberg Tribunal*, G.A. Res. 95(1), U.N. GAOR, 1st Sess., U.N. Doc. A/236 (1946).

80. *See generally* Richard Falk, *Telford Taylor And The Legacy Of Nuremberg*, 37 COLUM. J. TRANSNAT'L L. 693 (1999).

key office holders, Heinrick Himmler and Josef Goebels, were already dead.[81] However, key actors such as General Herman Goering, and Foreign Minister Joachim von Ribbentrop, were tried and sentenced to death.[82] Recognizing that the Tribunal was created by the victors, the chief prosecutor for the United States, Robert E. Jackson, stated, "If these men are the first war leaders of a defeated nation to be prosecuted in the name of the law, they are also the first to be given a chance to plead for their lives in the name of the law."[83] Even though a court of victor nations conducted the trials, which effectively preordained the outcome, those charged had the opportunity to plead their defense before a court.[84] For example, several of the lower ranking officers were eventually found not guilty and set free.[85] The Nuremberg Tribunal thus set the stage and the precedence for trying war criminals.[86]

Unlike Nuremberg, there were not yet any victors at the time of the creation of the ICTY Modern media coverage broadcasted war images worldwide, including the images of prisoner of war camps reminiscent of the German death camps of World War II.[87] International public opinion called for *something* to be done, and the United Nations responded with the creation of the ICTY in 1993.[88] The ICTY created an alternative to the costly use of military force by major powers. It allowed the United Nations to make up for its inability to stop the war by creating a tribunal to punish the perpetrators of crimes that the United Nations was unable to prevent.[89]

Although there was not a "victor" in the Balkan conflict, the Nuremberg precedent of "victors' justice" was the image that the ICTY has attempted to avoid with marginal success.[90] This desire for neutrality is buttressed by the unfortunate reality that a criminal court's effectiveness is dependent on its ability to exercise power over the criminal defendant. In order for a court to make an act by an individual who is foreign to the court illegal, such as had been done with the

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81. BEIGBEDER, *supra* note 44, at 35.

82. *Id.* at 35-36, 38.

83. *Id.* at 40-41.

84. *See id.* at 39

85. *Id.* at 38.

86. *Id.* at 39. Justice Robert Jackson, on leave from the United States Supreme Court has been credited with perhaps "the worst cross examination in history" for his treatment of Hermann Goering. His performance was of little matter, as Goering's guilt was predetermined. ***See*** Scott W Johnson and John H. Hinderaker, ***Guidelines for Cross-Examination: Lessons from the Cross-Examination of Hermann Goering***, 59 OCT. BENCH & B. MINN. 22 (2002).

87 National magazines in the United States, such as *Time* and *Newsweek*, ran full stories with horrifying images and international film crews like the *BBC* and *CNN* delivered the images as well of emaciated men in the Omarska, Kerraterm, and Trnopolje camps.

88. Ivan Simonovic, *The Role of the ICTY in the Development of International Criminal Adjudication*, 23 FORDHAM INT'L L.J. 440, 442 (1999).

89. Diplomatic attempts to stop the fighting between the former Yugoslav Republics continued to fail until the Dayton Peace Agreement in 1995. From 1993 to 1995, the ICTY served as token action by the international community towards an end to the conflict. BEIGBEDER, *supra* note 44, at 146-47

90. BASS, *supra* note 3, at 282. (quoting tribunal President Cassese, in reacting to the claims of victors justice, as stating "this is truly international institution, it is an expression of the entire world community, not the long arm of four powerful victors").

Nuremberg Tribunal and now with Milosevic, the court must also have the power to enforce its jurisdiction and to adjudicate the criminal matter.[91] The ICTY is able to exist and prosecute Milosevic because of NATO's subsequent bombardment and occupation of areas of the former Yugoslavia and the willingness of the Serbian leadership to turn him over to the ICTY

*3. The arrest and indictment*

Milosevic remained in Serbia for several months after his resignation in October 2000, even though he was a fugitive in the eyes of the international community.[92] The prosecutor for the ICTY indicted Milosevic during the second NATO bombing campaign alleging war crimes and crimes against humanity.[93] The indictment was issued sixty days into the NATO bombing campaign against Serbia, on May 22, 1999.[94]

In April 2001, almost two years after his indictment by the ICTY Serbian police arrested Milosevic.[95] Upon his arrest and confinement in a Serbian prison, President George W Bush released $50 million in aide to the Serbian republic for its capture and detention of Milosevic.[96] It was not clear what would have happened to Milosevic in the Serbian prison. By not acting however, it appears that NATO and other world powers were willing to let Milosevic remain in Serbian custody In addition, the recently elected President Kostunica was unwilling to turn Milosevic over to NATO powers.[97] Then, seemingly overnight, the United States and NATO changed gears, deciding that Milosevic should be tried by the ICTY and conditioned an additional $1.28 billion in aid on the surrender of Milosevic.[98]

President Kostunica remained reluctant to turn over Milosevic to the ICTY.[99] But in June 2001, Serbian Prime Minister Zoran Djindjic, a political rival, ordered Serbian police to take Milosevic to an American airbase in Bosnia.[100] From there,

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91. Alfred P Rubin, *Pining Guilt on Pinochet*, 6 ILSA J. INT'L & COMP L. 371, 372 (2000) (stating that "I know of no case in which war criminal or other supposed violator of "international criminal law" from major power has ever been tried by a neutral tribunal").

92. Charles Trueheart, *War Crimes Charge to be Announced Against Milosevic*, WASH. POST, May 27, 1999, at A1.

93. *Id.*

94. *Id.*

95. Not surprisingly, Milosevic was charged by the Serbian police with abuse of office and embezzlement, not crimes against humanity or genocide. Sam Cereste, *The International Court of Justice, the International Criminal Court, and the Ad Hoc Tribunals*, 17 N.Y.L. SCH. J. HUM. Rts. 911, 913 (2001).

96. SCHARF, *supra* note 18, at 37

97. *Id.*

98. *Id.* at 106. The requirement that Milosevic be turned over to the ICTY at The Hague served almost as an overnight reversal of United States foreign policy. United States Senator Mitch McConnell (R-KY) inserted an appropriations rider requiring that Milosevic be turned over to the international court as pre-condition for receiving any additional funds. *Id.*

99. *See Slobodan Milosevic Arrested, Charged with Corruption*, UN WIRE, Apr. 2, 2001, *at* http://www.unfoundation.org.

100. Marlise Simons and Carlotta Gall, *The Handover of Milosevic*, N.Y TIMES, June 29, 2001, at

he was flown to The Hague, Netherlands, for trial by the ICTY for genocide, war crimes, and crimes against humanity committed in the former Yugoslavia.[101] The charges stated that Milosevic had "planned, instigated, ordered, [or] committed" crimes prohibited by statute in Croatia, Bosnia, and Kosovo.[102] The newly elected government in the Federal Republic of Yugoslavia disagreed over the extradition, which lead to the resignation of several members. However, two days after the arrest of Milosevic, the Belgrade government was granted $1.28 billion in aid by NATO allies, quieting much of the political unrest that had been brewing for the new government.[103] The $1.28 billion put the world on notice regarding the amount of money that would be necessary to bring the former leader to trial.

## PART II —WHY HEAD OF STATE IMMUNITY DOES NOT APPLY TO MILOSEVIC

One might ask, "Why isn't Milosevic using the defense of head of state immunity to deny the ICTY from hearing his case?" A possible answer could be that he has other defenses that go to show that he in fact did not make the orders to carry out the killings by the Serb paramilitary forces in Croatia, Bosnia, or Kosovo.[104] Another answer, and one that Milosevic appears to follow by not raising the issue of head of state immunity,[105] is that traditional notions of sovereign immunity are disappearing in international law Current trends in international law show that criminally defined acts that are committed by any individual, whether they are done while serving as head of state, constitute crimes that may be tried by an international court. It will be argued that such crimes are no longer afforded immunity as political realities outweigh any immunity defense. This next section examines the deterioration of immunity for heads of states in international criminal law and the impact it has on Milosevic's trial.

### *1 Absolute immunity*

Traditional notions of sovereignty hold that internationally recognized nations are not to have their domestic affairs compromised by foreign nations.[106] This notion of sovereignty allows the political body of a state within a specific territory to be the sole arbiter of what constitutes legitimate behavior within that state.[107] While states can invite influence, such as in the form of financial or military aid, the ruling political entity remains the sole decision maker for the state leaving

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A1.

101. *Id.*

102. *See Indictment of the Prosecutor of the Tribunal Against Slobodan Milosevic,* IT-01-51-1, (1999).

103. SCHARF, *supra* note 18, at 37.

104. In fact a major issue facing the prosecution is the fact that Serb forces did not keep paper trail of orders, and most if any orders from Milosevic were made orally.

105. SCHARF, *supra* note 18, at 105.

106. STEPHEN D. KRASNER, SOVEREIGNTY ORGANIZED HYPOCRISY 19 (Princeton University Press 1999). The term absolute sovereignty stems from the Treaty of Westphalia signed in 1648 creating ideas of the modern state and allowing for actions within a state to be free from foreign scrutiny.

107. *Id.* at 20.

foreign states unable to interfere with the inner workings of the sovereign state.[108]

This notion of sovereignty also applied to heads of state who held immunity from civil or criminal prosecution at any point while serving as head of state or after their tenure.[109] In *Kahan v. Pakistan Federation*,[110] the English court held that a "foreign sovereign is entitled to immunity from civil proceedings in the courts of any other country, unless, upon being sued, he actively elects to *waive* his privilege and to submit to the jurisdiction."[111] While the action against the Pakistan Federation was a civil claim for a breach of contract,[112] the court stated, "It is established beyond question that a mere agreement by a foreign sovereign to submit to the jurisdiction of the courts of this country is wholly ineffective if the foreign sovereign chooses to resile from it."[113] The Pakistan Federation's agreement allowed the English court to resolve contract disputes,[114] but Pakistan later chose not to grant such jurisdiction when the matter came before the court.[115] Because of the rule granting immunity to the sovereign of a state, the court dismissed the complaint.[116] *Kahan* serves as an example of the application of absolute immunity where no state has jurisdiction in adjudicating claims against the sovereign state or its political head.

*2. Restrictive immunity*

The traditional notion of granting immunity to a head of state continued well into the last decade of the twentieth century in United States courts as shown by the case of the former president of Haiti, Jean-Bertrand Aristide, whowas elected in December 1990.[117] An unsuccessful military coup was attempted against President Aristide in January 1991, shortly after his election.[118] However, in September of the same year, Aristide fled Haiti after a second, and this time successful, coup.[119] While in exile, a resident of New York filed suit against President Aristide for killing her husband, Dr. Roger Lafontant, in federal district court in New York.[120] The complaint alleged that President Aristide ordered the execution of Dr. Lafontant shortly before Aristide was exiled because of the

108. *Id.* at 21.

109. *See* Mighell v. Sultan of Johore, 1 Q.B. 149 (1893) (finding that foreign sovereign acting as private individual and residing in England under an assumed name had sovereign immunity for breach of contract even though he had concealed the fact that he was a sovereign).

110. Kahan v. Pakistan Fed'n, 2 K.B. 1003 (1951).

111. *Id.* at 1013 (emphasis added) (quoting Mighell v. Sultan of Johore, 1 Q.B. 149 (1983)).

112. *See id.* at 1003.

113. *Id.* at 1012.

114. *Id.* at 1016

115. *Id.* at 1010.

116. *Id.* at 1016.

117. *See* U.S. Department of State, *Background Note: Haiti*, Apr. 2002, *available at* http://www.state.gov/r/pa/ei/bgn/1982.htm (last visited Oct. 31, 2002).

118. *Id.*

119. *See id.*

120. Lafontant v. Aristide, 844 F Supp. 128 (E.D.N.Y 1994).

doctor's participation in the failed coup attempt in January 1991.[121] Applying common law notions of absolute immunity, the court dismissed the complaint.[122] The court said that a "head of state recognized by the United States government is absolutely immune from personal jurisdiction in United States courts unless that immunity has been waived by statute or by the foreign government recognized by the United States."[123] The court reasoned that President Aristide, although in exile in the United States at the time of trial,[124] was recognized as the Head of State of Haiti by the United States government.[125] As such, the court did not have jurisdiction regardless of whether Aristide committed a crime that was not in furtherance of his official function as president.[126]

This similar doctrine of absolute immunity was claimed by General Manuel Antonio Noriega, but with a different result.[127] Noriega served as commander of the Panamanian Defense Forces when Panama's President Eric Arturo Delvalle asked for his resignation.[128] Noriega refused, and Delvalle was voted out of power.[129] The United States then invaded Panama with a significant military force and Noriega surrendered to United States forces after several days of seeking asylum with the Holy See.[130] The Eleventh Circuit dismissed Noreiga's claims of head of state immunity stating, "the Executive Branch [President George H. Bush] has manifested its clear sentiment that Noriega should be denied head of state immunity."[131]

By granting such deference to the executive branch of the federal government in both instances, the United States' Executive is able to determine who should receive immunity, disregarding the long held tenants of absolute immunity for heads of state. Just by recognizing a nation and its leader as legitimate allows that nation to be granted immunity for his or her actions while leader of that state. Such a blanket grant of power to the executive branch of government may appear overstated. However, the current trend in the doctrine of immunity allows international public opinion (or the opinion in the powerful countries) to decide

121. *Id.* at 130.

122. *Id.* at 139.

123. *Id.* at 131-32.

124. President Aristide did not return to power until October 1994, after the United States led a 21,000 strong force to enforce United Nations Security Council Resolution 940. The Resolution authorized member states to use all necessary means to restore the elected government to power. *See* U.S. Department of State, *Background Note: Haiti*, Apr. 2002, *supra* note 114.

125. *See* Lafontant, 844 F Supp. at 121.

126. *Id.* at 130. If, for example, the ICTY had jurisdiction over Aristide, he could be charged under Article 5 of the ICTY Statute, with crimes against humanity for acts conducted against civilian populations in Haiti since his return. See Human Rights Watch, *Haiti, the Human Rights Record of the Haitian National Police* (Jan. 1997) *available at* http://www.hrw.org/reports/1997/haiti/Haiti.htm#P62_1831 (last visited Nov. 13, 2002) (documenting several instances where the state run police, the Haitian National Police, has conducted extra-judicial executions and acceptance by the government of beatings and other abuses of civilian populations).

127 United States v. Noriega, 117 F.3d 1206 (11th Cir. 1997).

128. *Id.* at 1209.

129. *Id.* at 1209-10.

130. *Id.*

131. *Id.* at 1212.

who should be granted immunity Had the crime by President Aristide been different, or more importantly had it *not* been President Aristide, perhaps the court would have come to a different result. United States courts see head of state immunity not as "a matter of right but rather 'a matter of grace and comity'" where immunity is granted to those friendly with the nation.[132]

*3. Deterioration of immunity protection for heads of state*

The trial of Augusto Pinochet, the former leader of Chile, signaled a change in how nations deal with head of state immunity for crimes defined in international law [133] Pinochet ruled as President of Chile from 1973 to 1990 when he became a Senator for Life pursuant to the Chilean Constitution, and served as Commander-in-Chief for the army for another eight years.[134] Throughout his rule, over 3,000 political opponents were killed or "disappeared,"[135] some of whom were Spanish nationals.[136] In 1998 Pinochet was visiting the United Kingdom for medical treatment when he was arrested following his back surgery [137] The Spanish government requested his extradition to Spain charging Pinochet with murder, genocide, torture, and conspiracy to torture.[138] A divided panel of the House of Lords ruled that the doctrine of head of state immunity did not apply to actions that were inconsistent with international law [139] Lord Browne-Wilkinson stated that Pinochet would not be entitled to immunity if he "organised and authorised torture after 8 December 1988,[140] [for] he was not acting in any capacity which gives rise to immunity ratione materiae because such actions were contrary to international law" to which Chile had agreed.[141] Because Pinochet's actions in ordering the torture of certain individuals did not constitute an official function in his role as head of state, the court decided to allow for his extradition to Spain to stand trial.[142] Although Pinochet has not yet stood trial before the court due to health reasons, the decision of the House of Lords indicates a clear departure from the historical

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132. *See* Ved P Nanda, *Human Rights and Sovereign Immunity and Individual Immunities (Sovereign Immunity, Act of State, Head of State Immunity and Diplomatic Immunity) - Some Reflections*, 5 ILSA J. INT'L & COMP L. 467, 475 (1999).

133. *See* Charles Pierson, *Pinochet and the End of Immunity: England's House of Lords Holds that Former Head of State is not Immune for Torture*, 14 TEMP INT'L & COMP L.J. 263 (2000).

134. *Id.* at 264-65.

135. *Id.* at 265.

136. *Id.* at 266.

137. *Id.* at 266-67

138. Mike Meier & John. R. Schmertz, *House of Lords Rules that Crimes of Torture Allegedly Committed During Pinochet Regime in Chile are Extraditable to Extent they Occurred After Ratification of Torture Convention by Chile, Spain and United Kingdome in late 1988; Head of State Immunity Held Inapplicable to Torture Charges as Jus Cogens Offenses*, 5 INT'L L. UPDATE 41 (1999).

139. *Id.*

140. In 1998, the United Kingdom adopted the International Convention Against Torture and Other Cruel, Inhuman, or Degrading Treatment or Punishment, allowing for the prosecution of individuals charged with torture.

141. *Regina v. Bartle and the Comm of Police for the Metropolis & Others Ex Parte Pinochet*, 38 I.L.M. 581, 594 (1999).

142. *Id.* at 643.

notions of head of state immunity. Even if the acts were official, they may still violate international law

The dissenters took a narrower view of what activities constitute official duties.[143] Lord Millet stated that just by agreeing to the Torture Convention, Chile had not waived immunity for its former head of state.[144] Pinochet's acts were in fact government acts: signing orders designed to be carried out by government officials. Head of state functions, according to the dissenters, are not to be determined by international law, as even an oppressive government is still a government.[145]

In times of conflict, immunity has not been granted to those who were beaten. Rather, immunity is often used as a bargaining chip to bring about an end.[146] Immunity is used by powerful nations to encourage regime changes.[147] For example, to encourage peaceful transitions of power, the United Nations has helped negotiate amnesty for leaders of the apartheid regime in South Africa, the Khmer Rouge in Cambodia, and leaders of the military regime in Haiti.[148] Furthermore, states (and the public opinion within those states) have become more willing, as is evident with Milosevic, to try individual leaders in their executive capacity due in part to an increasing significance and acceptance of international human rights law [149] Much like the Nuremberg court, the desire to put leaders on trial for their actions *after* the international community has decided to act plays an important role in deciding who is tried and for what crimes.

Professor Stephen Krasner calls sovereignty an "organized hypocrisy" where the sovereignty of nations is "frequently compromised through intervention in the form of coercion or imposition by more powerful states, or through contracts or conventions that have involved invitations for external actors to influence domestic authority structures."[150] Where a nation and its leaders are free to act within their particular borders, traditional notions of sovereignty are only followed or agreed to when major nations lack the will to intervene. Professor Krasner states that nations

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143. *Id.* at 652.

144. *Id.* at 651 (Lord Millet).

145. *See* Charles Pierson, *Pinochet and the End of Immunity: England' House of Lords Holds that Former Head of State is not immune for Torture*, 14 TEMP INT'L & COMP L.J. 263, 291 (2000).

146. Michael Scharf, *The Amnesty Exception to the Jurisdiction of the International Criminal Court*, 32 CORNEL IN'TL. L.J. 507 514 (1999) (stating "When the international community encourages or endorses amnesty for human rights abuses, it sends signal to other rogue regimes that they have nothing to lose by instituting repressive measures. Such regimes can always bargain away their crimes by agreeing to peace").

147. *See generally* Larry Rohter, *Mission to Haiti*, N.Y TIMES, Oct. 5, 1994 at A1.

148. SCHARF, *supra* note 18, at 48-9

149. JURGEN BROHMER, STATE IMMUNITY AND THE VIOLATION OF HUMAN RIGHTS 221 (Kluwer Law International 1997). Jurgen Brohmer argues that the growing jurisprudence of international humanitarian law contradicts many of the notions of sovereign immunity. It is further argued that notions of sovereign immunity should be further restricted when there are violations of human rights through the adoption of a *Convention on State Immunity* that allows for adjudication of violations of human rights in another state effectively allowing states to try leaders in foreign jurisdiction for violations of humanitarian law.

150. KRASNER, *supra* note 103, at 125, 220.

have intervened in certain target nations for state intolerance of minority populations or religious factions when there was support within the intervening nation for such intervention.[151] United States foreign policy set by the Executive Branch, specifically the State Department, not theoretical notions of state sovereignty determined the outcomes of Noriega and Aristide. Both leaders claimed to be the head of state for their respective nations, and for practical purposes each was the acting head of state, but the label used by the State Department allowed the courts to make their respective judgments. As applied to Milosevic, only after images of forced relocations of ethnic Albanians from the Republic of Kosovo and reports of killings and rapes did NATO breach Yugoslavian sovereignty with a major bombing campaign (keeping its forces mostly out of harm's way). Also at this point, the ICTY delivered its indictment of Milosevic.[152]

*4. ICTY statute and immunity*

The statute of the ICTY does not provide immunity protection for any persons charged in the former Yugoslavia.[153] In so doing, the United Nations Security Council decided that notions of absolute or even restrictive immunity would not apply [154] The statute gives the tribunal the power to prosecute "a person who planned, instigated, ordered, committed or otherwise aided" in the commission of a breach of the 1949 Geneva Convention, violation of the law of war, genocide, or crime against humanity "[155] The statute further states that, "the official position of any accused person, whether as Head of State or Government shall not relieve such person of criminal responsibility nor mitigate punishment."[156] In enacting the statute, the tribunal does away with the head of state immunity defense for actions undertaken while serving in the capacity of head of state or other official position.[157]

Even though the statute allows for the prosecution of Milosevic in his role as head of state,[158] such an activity was probably not necessary. The statute codifies the demise of any notion of immunity for officials acting against the norms established by the ICTY [159] New notions allowing for the prosecution of heads of state for their participation, albeit from a removed leadership role of giving orders or even just knowing that such acts are occurring, in war crimes and crimes against humanity would have allowed for the prosecution of Milosevic in other criminal courts. As one scholar stated, "If there is a conflict between the interests of the

151. *Id.* at 125-26.

152. The Milosevic indictment was delivered on November 22, 2001.

153. Statute of the International Tribunal for the Former Yugoslavia (May 25, 1994) Res. 827 (as amended May 13, 1998 by Res. 1166 & Nov. 30, 2000 by Res. 1329).

154. *Id.*

155. *Id.* at art. 7, para. 1.

156. *Id.* at para. 2.

157. *Id.*

158. *See id.* at art. 7, para. 2.

159. *Id.* at para. 1.

state and the interest of the individual it can no longer be maintained that the interests of the state must always and per se prevail."[160] Gross violations of human rights may cause nations to intervene and violate sovereignty for the stated purpose of ending such violations, as in the Balkan states, and be approved by international law.

*5. Extradition of Milosevic*

Milosevic, on his flight to The Hague with his United States captors and officials from the ICTY claimed he was being kidnapped.[161] The ICTY rejected this argument of kidnapping in violation of international law on the basis that a formal extradition treaty existed between the court and the Federal Republic of Yugoslavia.[162] The ICTY is unable to enter Yugoslavia and capture any of the indicted individuals and is dependent upon international cooperation for capturing war criminals like Milosevic.[163] Without a police force, it is reliant upon other nations to enforce its jurisdiction over any of the "fugitives" that it seeks.[164]

The Milosevic arrest is not the first instance of international kidnapping sanctioned by the courts. One of the most well known abductions was the abduction of former Nazi leader Adolf Eichmann by an Israeli Special Forces unit while he was in Argentina after World War II.[165] Although Israel was forced to pay reparations to Argentina for violations of its sovereignty[166] the actual kidnapping was allowed.[167] Eichmann faced trial by the Israeli court and was eventually convicted and put to death for his participation in killing of millions of Jews during World War II.[168] This was also the case with the arrest of Panamanian General Noriega who was carted off to a United States court after soldiers invaded Panama.[169] Following the United States Supreme Court's ruling in *United States v. Alvarez-Machain*,[170] the court adjudicating the claims against Noriega said that in order to prevail on an extradition treaty claim, Noriega had to show that the United

160. BROHMER, *supra* note 146.

161. SCHARF, *supra* note 18, at 106.

162. *Id.*

163. *See* Judge Gabrielle Kirk McDonald, *Address to the United Nations General Assembly* (Nov. 8, 1999), *available at* http://www.un.org/icty/pressreal/p445-e.

164. *Id.*

165. *See generally* HANNAH ARENDT, EICHMANN IN JERUSALEM (Penguin Books 1994) (1963).

166. *See* U.N. SCOR, 15th Sess., 867th mtg., at 1-2, S/P V 867 (1960). For history of the diplomatic efforts between Argentina and Israel, see Mathew Lippman, *Genocide: The Trial of Adolf Eichmann and the Quest for Global Justice*, 8 BUFF HUM. RTS. L. REV. 45, 54-64 (2002).

167. *Id.*

168. In addition to the issues regarding Eichmann's extradition from Argentina, Eichmann's appearance created an obvious fiction in Israeli law where the accused is deemed innocent until proven guilty. In explaining why Israel had violated Argentine law, Israeli Prime Minister Ben-Gurion said, "it was Eichmann who organized the mass murder, on a gigantic and unprecedented scale. *See* ARENDT, *supra* note 166.

169 United States v. Noriega, 117 F.3d 1206, 1210 (11th Cir. 1997).

170. United States v. Alvarez-Machain, 504 U.S. 655 (1992) (holding that the abduction of a criminal defendant from nation with whom United States has extradition treaty is not in violation of treaty and may be tried in district court for criminal law violations).

States had agreed not to seize him.[171]

Professor Sheri Burr poses the question of whether kidnapped individuals accused of human rights violations possess a legal right to be brought before an international court.[172] Her answer is no, claiming that such actions are not morally or legally justified and makes citizens of states feel less secure.[173] Furthermore, she argues that the kidnapping of alleged offenders erases their rights to fair trials and benefits the powerful states that have the means to conduct a successful kidnapping.[174] Although these concerns may be valid, so long as the nation is allowed reparations for the violation of its territorial integrity, and there is a desire by the international community to see that the individual is brought before a tribunal, the international community appears willing to allow for the kidnapping of officials and others.[175] While the ICTY has decided that it does have jurisdiction over individuals who are brought to stand trial before it against their will,[176] the question remains how other courts, such as the ICC, will be able to assert jurisdiction over an individual brought before it.

## PART III —RATIONALIZING MILOSEVIC'S TRIAL

The indictment of Milosevic was handed down in May 1999 sixty days after the NATO bombing campaign began, eight years after the conflict in Yugoslavia started, four years after Milosevic signed the Dayton Peace Accords, and well after the arrival of thousands of United Nations peacekeeping troops. It came at a time when support in NATO nations for activities in the former Yugoslavia was declining.[177] The bombing of the Chinese Embassy in Belgrade, and the use of cluster bombs and depleted uranium munitions on military and civilian targets, strengthened political opposition in NATO countries.[178] It appears that the Milosevic indictment was delivered at such a time to show that an end of the conflict, and therefore foreign involvement, was in sight and there was a goal of arresting and bringing to justice international war criminals.

### *1. Non-cooperation of Yugoslav republics*

Since the creation of the ICTY the main problem that the tribunal has faced has been its inability to arrest and put on trial the leaders in the former Yugoslavia responsible for the atrocities. With the exception of Milosevic, the other major

171. Noriega, 117 F.3d at 1213.

172. Sheri L. Burr, *From Noriega to Pinochet: is there an International Moral and Legal Right to Kidnap Individuals Accused of Gross Human Rights Violations*, 29 DENV. J. INT'L L. & POL'Y 101 (2001).

173. *Id.* at 114.

174. *Id.* at 112.

175. *See* Alvarez-Machain, 504 U.S. at 655.

176. *See* Prosecutor v. Dusko Tadic, Judgment of the Trial Chamber, IT-94-1-A (1997) (stating "The Statute grants competence to prosecute persons responsible for serious violations of international humanitarian law committed in the territory of the former Yugoslavia since 1991").

177 SCHARF, *supra* note 18, at 102.

178. *Id.*

Bosnian-Serb leaders Radovan Karadzic and Ratko Mladic have been charged with war crimes but remain at-large.[179] As of March 2004, the ICTY has issued over 110 indictments with ninety-one individuals in proceedings before the tribunal.[180] Twenty indicted individuals however, remain at large.[181] Without any enforcement power at its disposal, the ICTY has relied upon "dumb luck" for finding and arresting those before the tribunals. [182] The current governments of the nations making up the former Yugoslavia have been reluctant to turn over war criminals to the Tribunal, putting into question the court's effectiveness.[183] The United States has made some efforts to pressure the nations of the former Yugoslavia into cooperating with the ICTY [184] In May 2002, a freeze on financial assistance was lifted and roughly $40 million in aid and $300 million in frozen assets were handed over after Yugoslav officials agreed to respond to document requests.[185]

Former ICTY President Claude Jorda recently complained, "The Federal Republic of Yugoslavia is not co-operating in tracking down, arresting and transferring to The Hague certain of the accused."[186] While arrest warrants have been issued and evidence for other indictments requested, these requests have been summarily ignored.[187] The refusal to cooperate extends beyond Serbia. For example, Croatia has refused to turn over General Janko Bobetko, indicted for killing over 100 Serbs in a 1993 military campaign, with the official position that the massacre was part of a legitimate military operation.[188] However, since some leaders in Serbia saw fit to allow United States troops to take Milosevic to The Hague rather than see him tried in Serbian courts, the ICTY has its first "big catch. Therefore, the inability of the ICTY to function without international assistance is a major weakness of the court.

*2. Factors causing international intervention*

NATO's intervention into the Balkan region poses several questions as to the legality of the act under international law.[189] Article 2 (4) of the United Nations

179. *Id.*

180. *Id.*

181. *Id.*

182. *See, e.g.*, SCHARF, *supra* note 18, at 250-51 (describing an arrest that took place in January of 1996 when Bosnian Serb General Djordje Djukic and Colonel Aleksa Krsmanovic took a wrong turn in the city of Sarajevo and ran into the Bosnian police who promptly arrested them even though neither had been indicted by the ICTY The two were transferred to a Bosnian jail where French soldiers took them away to a United States airbase and then to The Hague. Upon their arrival, prosecutors scrambled and General Djukic received an indictment and Colonel Krsmanovic was eventually set free).

183. BEIGBEDER, *supra* note 44, at 161-2.

184. Bruce Zagaris, *Yugoslav Tribunal Flourishing*, 18 INT'L ENFORCEMENT L. REP. 310 (2002)

185. *Id.*

186. *Hague Tribunal Calls for UN Pressure on Belgrade*, REUTERS NEWS, Oct. 23, 2002.

187. *Id.*

188. *Britain Demands Croatia Accept Indictment of War Criminal*, AP NEWSWIRES, Oct. 15, 2002.

189. For example, the Russian Federation proposed a United Nations Security Council resolution to require NATO to cease bombing and declare the act as unlawful but was vetoed by the NATO states. *See Security Council Rejects Demand for Cessation of Use of Force against Federal Republic of Yugoslavia*, UN press Release SC/6659 (Mar. 26, 1999).

charter asks members to "refrain" from the "threat of force or use of force" in conducting their international relations.[190] The Article was violated by NATO's threat and ultimate use of air strikes against Yugoslavia.[191] However, since the end of the Cold War, there has been a shift in international law that allows for the justification of intervention on "humanitarian" terms; internal conflicts involving human rights violations or other crimes against humanity pose a threat to international peace and security and thereby provide the authority to intervene.[192] In addition to sending peacekeeping troops to the Balkans, the United Nations has attempted such humanitarian intervention in Somalia, Rwanda, and in East Timor.[193] In Somalia, however, United Nations, and United States, casualties quickly turned the stomach of nations sending peacekeeping forces.[194] The United Nations' failure in Somalia to stop warring factions led to its reluctance to intervene in Rwanda[195] and then later to deploy troops in Bosnia[196] but to keep them out of harm's way. But, the prospects of providing humanitarian assistance to the Kosovars, after the international community witnessed the ramifications of earlier failures including efforts in Bosnia, allowed NATO to act albeit without Security Council authorization.[197]

Professor Gary Bass argues that there are limits for when a liberal, or democratic, state will act.[198] The idealism that can cause a state to act against the "face of foreign wickedness" can also cause a turning away and abandonment of the pursuit of justice.[199] According to Professor Bass, there are a number of factors that cause a liberal state to pursue war criminals through an international criminal

190. U.N. CHARTER art. 2, para. 4.

191. *See* Bruno Simma, *NATO, the UN and the Use of Force: Legal Aspects, Kosovo: A Thin Red Line*, 10 EUR. J. INT'L. L. 1 (1999), *also available at* http://www.ejil.org/journal/Vol10/No1/ab1-2.html#Heading2.

192. *See* Louis Henkin, *NATO's Kosovo Intervention: Kosovo and the Law of "Humanitarian Intervention*, 93 A.J.I.L. 824, 825 (1999) (arguing that unless the military action is sanctioned by the Security Council, unilateral or even collective action such as the NATO bombing of Serbia after its invasion of Kosovo, is unlawful); *see also* Ved P Nanda, *Human Rights and Sovereign and Individual Immunities (Sovereign Immunity, Act of State, Head of State Immunity and Diplomatic Immunity) – Some Reflections*, 5 ILSA J. INT'L & COMP L. 467 (1999) (arguing that a human rights exception ought to be added to the United States Foreign Sovereign Immunities Act "to allow the law to catch up with the monumental progress of international human rights law").

193. *See Background Note, United Nations Peacekeeping Operations*, Jan. 15, 2004, *available at* http://www.un.org/peace/bnote010101.pdf.

194. *See e.g.*, Editorial, *The United Nations at 50*, N.Y TIMES, June 26, 1995, at A14.

195. Secretary General Kofi Annan said, "Confronted by gross violations of human rights in Rwanda and elsewhere, the failure to intervene was driven more by the reluctance of Member States to pay the human and other costs of intervention, and by doubts that the use of force would be successful, than by concerns about sovereignty. *See Report of the Secretary-General on the Work of the Organization*, U.N. GAOR, 54th Sess., 4th plen. Mtg., at 1, U.N. Doc. A/54 PV 4 (1999).

196. *Id.*

197. *See* Simma, *NATO, the UN and the Use of Force: Legal Aspects, Kosovo: A Thin Red Line*, 10 EUR. J. INT'L. L. 1 (1999) (stating "we would be well advised to regard the Kosovo Crisis as a singular case in which NATO decided to act without Security Council authorization out of overwhelming humanitarian necessity, but from which no general conclusion out to be drawn).

198. *See generally* BASS, *supra* note 3.

199. *Id.* at 5.

court.[200] These factors are a sense of legal norms, desire to protect the intervening nation's soldiers over the lives of foreigners, an appearance that there has been war against the liberal states, public opinion is such that the outrage is able to influence the democratic process, and there is pressure by non-state actors such as non-governmental organizations.[201] In applying these factors, it makes sense why the United Nations chose to establish a tribunal rather than use ground forces to stop the war in the region. The United States and the international community did not want to intervene forcefully but were willing to make the effort to provide a court where those responsible for the carnage would be brought to justice. The United States' reluctance to intervene during the height of the conflict in the early 1990's was evident when President Bill Clinton in May 1993, refused again to send troops to the region saying "we don't want our people in there, basically in a shooting gallery."[202] It was not until the downing of an American pilot and the capture of three American soldiers in 1999 did support for more action grow in the United States and NATO intensified its air bombings.[203]

There are numerous places where an international tribunal such as the ICTY could be applied but the international community has decided not to take action against the heads of state even after they have left their positions and are either living or have lived abroad. Some of these suspected criminals include: Pol Pot, leader of the Khmer Rouge and head of state during the killing fields in Cambodia;[204] Idi Imin, former ruler of Uganda, who lives in exile and is suspected of over 300,000 politically motivated killings;[205] Mengistu Haile Mariam, former Ethiopian dictator, also in exile, and allegedly responsible for up to 1 million Ethiopian deaths;[206] Jean Claude Duvalier, former Haitian President, who along with his father are estimated to have ordered the deaths of between twenty and thirty thousand Haitian civilians;[207] and former Indonesian General Suharto who may be responsible for thousands of civilian deaths when he came to power in the mid 1960's, and later when Indonesian forces invaded East Timor in 1975.[208]

Where the United Nations has decided to intervene there have been results.[209] Former Prime minister of Rwanda, Jean Kambanda, was sentenced to life in prison

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200. *Id.*

201. *Id.* at 29-35.

202. Quoted in *id.* at 214.

203. *See* George Jahn, *Captured US Soldiers To Be Tried*, ASSOCIATED PRESS Apr. 1, 1999.

204. No state was willing to put Pol Pot on trial for his actions as leader and died prior to the establishment of tribunal similar to the ICTY All but two of the prominent Khemr Rouge figures remain free. *See* Mary Margaret Penrose, *It's Good to be the King!: Prosecuting Heads of State and Former Heads of State Under International Law*, 39 COLUM. J. TRANSNAT'L L. 193, n. 9-10 (2000).

205. *Id.* at note 11.

206. *Id.* at note 12.

207. *See* Human Rights Watch, *Haiti, Thirst for Justice, a Decade of Impunity in Haiti*, 1996, *available at* http://www.hrw.org/reports/1996/Haiti.htm (crediting the Duvaliers with driving hundreds of thousands of Haitians into exile, fleeing official torture and murder).

208. *Suharto Crimes Against Humanity*, INSIDE INDONESIA DIGEST 60, May 22, 1998, *available at* http://www.insideindonesia.org/digest/dig60.htm (last visited Jan. 26, 2004) (arguing for an international criminal tribunal similar to the ICTY for crimes committed by the Suharto regime).

209. *Id.*

for crimes against humanity and genocide against the civilian Tutsi population in Rwanda.[210] Kambanda was turned over to the International Criminal Tribunal for Rwanda after Kenyan authorities arrested him.[211] This dynamic, where certain individuals are prosecuted, or even indicted, is representative of a system of international law that is "constrained on one end by voluntary compliance of consenting sovereign states and on the other by the political deadlock of the moment."[212] Only after the international community achieves a political will and states which are harboring suspected criminals opt to participate are those who caused the atrocities put to trial. It took a significant NATO bombing campaign, a regime change, and the arrest and subsequent middle of the night extradition, for Milosevic to come to trial.[213]

While the world continues to sit idle as other atrocities continue, the desire of the ICTY to avoid appearances of "victors' justice" is doomed. Without the consistent application of international law to all individuals, the stigma and precedent of the Nuremberg court will remain. "In the last analysis, the two international war crimes tribunals in The Hague and Arusha stand largely as testaments to the failure of America and the West. Had the West managed to summon the political will to stop the slaughters in Rwanda and Bosnia, there would have been no need for these two fragile experiments in international justice."[214] Professor Bass sees the experience of the war crime tribunals as having potential to work.[215] But with the exception of Nuremberg, they have not worked as well as possible.[216] The ICTY began with a lengthy trial of an insignificant player, Dusko Tadic, not the way that would have given the tribunal the legitimacy or recognition that it needed.[217] Now with the potential that Milosevic may continue his lengthy trial to his death, or even to victory as some have questioned, the lack of success of the ICTY to prosecute the high-ranking officials of the Balkan conflict may spell the practical demise of a functioning and operational International Criminal Court.

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210. *See* The Prosecutor v. Jena Kambanda, Judgment and Sentence of Sept. 4, 1998, ICTR 97-23-S, *available at* http://www.ictr.org, (last visited Nov. 17, 2002).

211. *Id.*

212. *See* Penrose, *supra* note 201.

213. BASS, *supra* note 3 at 240 (stating that at the end of the Dayton Peace Accords in 1995, seventy-percent of the American public did not want to see troops in Bosnia: one poll conducted by the White House stated that the last thing that American troops should be used for was arresting war criminals)., *See* Mary Margaret Penrose, *Lest We Fail: The Importance of Enforcement in International Criminal Law*, 15 AM. U. INT'L L. REV. 321, 340 (1999) (arguing that courts such as the ICTY should not precede the end of a conflict without first establishing a mechanism to ensure enforcement); *See* Prosecutor v. Erdemovic, Case No. IT-96-22, Int'l Crim. Trib. for the Former Yugo., Trial Chamber, Sentencing Judgment (May 29, 1996), *available at* http://www.un.org/icty/judgement.htm; *see also* Article 24 of the Statute of the ICTY (stating that "the penalty imposed by the Trial Chamber shall be limited to imprisonment").

214. BASS, *supra* note 3, at 283.

215. *Id.* at 310.

216. *Id.*

217 Fact Sheet on ICTY Proceedings, *at* http://www.un.org/icty/glance/index.htm.

## PART IV — THE LEGACY OF THE TRIAL

The trial of Slobodan Milosevic brings many "firsts" to international criminal trials. In addition to the first trial of a head of state for war crimes, the trial has brought wartime adversaries into the opposing sides of a courtroom, with one head of state testifying against another.[218] The trial of Milosevic, and others at The Hague, will have lasting impacts in the region and the world, especially with the creation of the ICC, as Milosevic's trial is certain to be a "harbinger of [the] future when there will be more trials like this."[219]

### *1 Impact in the former Yugoslavia*

The international community hopes that the Milosevic trial and the ICTY will help create some healing in the former Yugoslavia.[220] This in part has already happened with the uneventful reelection attempt of Vojislav Kostunica as President of the Republic of Yugoslavia.[221] Milosevic's trial also has played an important role in increasing the tribunal's effectiveness and credibility.[222] Furthermore, the trial may help educate the people of Croatia, Bosnia and Herzegovina, Kosovo, Serbia, and the world as to what happened so that such acts do not occur in the future. However, reliance upon the tribunal to prosecute war criminals by the governments of the Balkan states has not served to develop local war crimes prosecutions in the regions of the former Yugoslavia.[223]

In order for the ICTY to meet its goals, the international community should take a sincere interest in the ICTY's operations. The yearly budget of the ICTY has increased from $276,000 in 1993 to over $223,000,000 for 2002-2003 and a staff of 1238 from eighty-four countries.[224] Yet, with the increase in staff and resources, the ICTY continues to face critical resource shortages.[225] It also struggles with logistical problems such as providing a place where convicted war criminals are to be imprisoned; making it reliant upon United Nations member states to house convicted criminals.[226] The ICTY also does not have any

218. Marlise Simons, *Croat Leader Says Milosevic Made "Rivers of Blood,* N.Y TIMES, Oct. 2, 2002, at A7 (describing the testimony of Croatian President Stjepan Mesic against Milosevic, and appearing as the first head of state to appear as witness at the ICTY).

219. *Id.* (quoting Richard Dicker).

220. *Id.*

221. *See* Misha Savic, *President Kostunica Carries on Legal Battle over Failed Elections,* AP NEWSWIRES, Dec. 14, 2002 (reporting that some argue that there is a lack of interest in that not enough people are voting to satisfy the constitutional requirements).

222. *See* David Tolbert, *The International Criminal Tribunal for the Former Yugoslavia: Unforeseen Successes and Foreseeable Shortcomings,* 26 FLETCHER F WORLD AFF 7 (2002) (arguing that the increase in credibility comes after NATO troops allowed indicted individuals, such as Mladic and Karadzic, to pass through checkpoints without arrest).

223. *Id.* at 15 (citing the failure of the ICTY to have a significant impact on the region's justice system as a major failure of the ICTY "tarnish[ing] the successes that the tribunal has seen").

224. Fact Sheet on ICTY Proceedings, *available at* http://www.un.org/icty/glance/index.htm (last visited Jan. 26, 2004).

225. *Id.*

226. *Id.*

enforcement mechanisms to make sure that those who are indicted are brought to trial.[227] As it is, the ICTY is dependent upon NATO and the United Nations to bring the indicted individuals to trial.[228] Without a police force and a jail, the basic necessities of a criminal justice system,[229] it promises to continue to be an uphill battle of legitimacy for the ICTY

The ICTY was created in the midst of fighting in Yugoslavia.[230] Cries for an end to the conflict from those who became refugees, lost loved ones, or had their homes destroyed found little comfort when the international community sent resources to the establishment of a court in The Hague to try those who were at the time in the *act* of causing harm.[231] It will be hard for those who were forced to flee their homeland from the fighting and destruction to not be skeptical of promises of justice. Unlike the Nuremberg Trials, where the sentence of death was possible, the ICTY statute limits punishment to imprisonment.[232] Concerns over the legitimacy of the death penalty aside, the inability to impose such a penalty may also cause greater skepticism that "justice" will be done when those who have lost all that they have seek vengeance rather than "justice."[233]

*2. Impact on the establishment of the ICC*

In an attempt to do away with ad hoc criminal tribunals, the United Nations General Assembly convened the United Nations Diplomatic Conference of Plenipotentiaries on the Establishment of an International Court, which created the Rome Statute of the ICC.[234] Nations within the international community have been trying for some time to establish such a court[235] before the statute came into effect on July 1, 2002.[236] The ICC was created to prosecute those responsible for international crimes.[237] United Nations Secretary-General Kofi Annan stated, "In the Prospect of an international court lies the promise of universal justice."[238] The

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.*

231. *See* Penrose, *supra* note 210.

232. Prosecutor v. Erdemovic, *supra* note 210.

233. *Id.*

234. *Rome Statute of the International Criminal Court Overview, available at* http://www.un.org/law/icc/general/ overview.htm (last visited Nov. 19, 2002).

235. *Id.* (discussing the history dating back fifty years from when the United Nations first recognized the need to establish an international criminal court).

236. The United Nations Diplomatic Conference of Plenipotentiaries on the Establishment of an International Criminal Court adopted the statute creating the ICC on July 17, 1998, in Rome, Italy. There are currently 139 signatories to the treaty, and eighty-four who have ratified it. Although the United States signed the treaty in 2000, in May of 2002, the United States withdrew from the treaty. *See Rome Statute of the International Criminal Court: Ratification Status, available at* http://untreaty.un.org/ENGLISH/bible/englishinternetbible/partI/chapterXVIII/ treaty10.asp (last visited Nov. 19, 2002).

237 Rome Statute of the International Criminal Court, July 17, 1998, U.N. Doc. A/Conf.183/9 (1998), reprinted in 37 I.L.M. 999 (1998) (hereinafter Rome Statute).

238. *Id.*

goal of the ICC to help end conflict, to act when other criminal justice institutions are unwilling, and deter future war criminals[239] is dependent upon being able to exercise jurisdiction over the "wrong-doers.

The ICC will have jurisdiction over "the most serious crimes of concern to the international community as a whole" including the crime of genocide, crimes against humanity, war crimes and the crime of aggression.[240] Just like the ICTY the ICC does not recognize head of state immunity.[241] The statute states, "official capacity as a Head of State. shall in no case exempt a person from criminal responsibility under this Statute, nor shall it, in and of itself, constitute a ground for reduction of sentence."[242]

Many see the ICTY as a trial run for how the ICC will proceed.[243] Some commentators claim that the ICC does not solve the problems that are inherent in international criminal justice.[244] Judge Gabrielle Kirk McDonald in her address to the United Nations said, "Mr. President, the international community is in the initial stages of establishing the ICC. Make no mistake about it: if the international community does not ensure that the orders of the Court are enforced, it is bound to go the way of the League of Nations."[245] Without an international police force to enforce violations of international criminal law, the effect of the ICC would be to serve as an international reprimand for criminal acts. Indictments, such as those delivered by the ICTY against the Bosnians Ratko Mladic and Radovan Karadzic, would go unheeded unless there is some incentive for the country to turn over the individual or unless it has no choice.

The ICC foresees a world where nation states will assist in the implementation and enforcement of international law.[246] Enforcement mechanisms of the ICC are similar to the ICTY with both placing a "general obligation to cooperate" upon states in the prosecution and investigation,[247] and leaving states to "continue to pursue their own self-interests at the cost of enforcing international law."[248] The court can only work effectively with participation at all times by all

239. *Id.*

240. *Id.* at art. 5, sec. 1.

241. *Id.* at art. 27, sec. 2.

242. *Id.* at art. 27, sec. 1.

243. *See* David Tolbert, *The Evolving Architecture of International Law*, 26 FLETCHER F WORLD AFF 7, 8 (2002) (stating, "The ICTY has grown into an effective court, which has painstakingly administered trials that are widely perceived as fair. In the process, the tribunal's judges have developed an important body of international law and criminal procedure that will serve as critical guideposts for the ICC as well as other prosecutions for serious violations of international humanitarian law.").

244. *See* William Miller, Comment, *Slobodan Milosevic Prosecution by the International Criminal Tribunal for the Former Yugoslavia: A Harbinger of Things to Come for International Criminal Justice*, 22 LOY L.A. INT'L & COMP L. REV. 553 (2000) (citing the potential major problems with the ICC are issues of state sovereignty and cooperation of states as well as overcoming political obstacles).

245. *See* Judge Gabrielle Kirk McDonald, *Address to the United Nations General Assembly* (Nov. 8, 1999), *available at* http://www.un.org/icty/pressreal/p445-e.

246. *See* Penrose, *supra* note 210, at 352.

247. *Id.*

248. *Id.* at 356. Professor Penrose continues, "International criminal law cannot depend on the

involved. However, as seen with Milosevic, states are willing to satisfy their self-interests and provide a court to resolve disputes or try criminals when it satisfies those interests.

*3. What if Milosevic wins?*

Milosevic, who is a trained lawyer, has so far put on a good show. The question then, is what happens if the prosecution is unable to tie him to making the orders to conduct the mass executions and other crimes that he is charged with committing and, as a result, he wins. Of course, it is not clear what will happen; presumably if he wins, he would return to Serbia and face whatever trial may be conducted for abuse of power. If convicted, he would likely serve the rest of his life in a European prison.[249] But the end result to Milosevic, who may not even be able to finish the trial based upon his failing health, is perhaps insignificant compared to the precedent that his trial will establish in trying heads of state before the ICC.

If Milosevic wins, then the international community may be less likely in the future to seek out war criminals and bring them before a tribunal. It would appear easier and a less lengthy process to attempt to kill the leaders either by assassination or bombing then go through the long drawn out process of a trial with the potential of not convicting the leader.[250] If Milosevic loses, then nations will have a precedent regarding the level of resources required to convict such an individual. States may also require bribes and/or bounties in order to turn over suspected criminals, as has been the case with the ICTY [251]

Cases that will go to the ICC are those where the local courts would not charge an actor for his participation in a crime against humanity, war crime, or crime of genocide.[252] Therefore, it is unlikely for an individual who is not convicted by the ICC to be tried in his or her home country afterwards. If the country has little incentive to turn over the individual in the first place, then it would also have little incentive to cooperate with the ICC and produce the

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acquiescence of powerful nations. Otherwise, international tribunals return to the setting of "victors' justice, which begs the question whether international criminal law is capable of equitable distribution. Without salient enforcement, international criminal law provides only the enticing mirage of justice. *Id.* at 364.

249. *See* Statute of the International Tribunal, *supra* note 150, at art. 27 As of March 11, 2004, ten nations have signed agreements with the United Nations to enforce sentences delivered by the ICTY These include Italy, Finland, Norway, Sweden, Austria, France, Spain, Denmark, Germany, and the United Kingdom. Press Release, United Nations, The United Kingdom The 10th State to Sign an Agreement on the Enforcement of Sentences With the ICTY, (Mar. 11, 2004), *available at* http://www.un.org/icty/pressreal/2004/p830-e.htm.

250. The United States war with Iraq provides an example of where numerous attempts to kill the leader of Iraq, Sadam Hussein, failed only to later find him and take him prisoner. The United States has assured people that his trial will be "fair and transparent, however, it does not appear that an impartial tribunal will sit in judgment of the former dictator. *See* Neil Lewis, *Bush Leaves Unclear Role of Iraqis in Any Trial*, N.Y TIMES, Dec. 15, 2003, at A18.

251. *See* discussion in Part I (3) of this paper.

252. Rome Statute, art. 5, sec. 1.

documents and required materials for a conviction.

## CONCLUSION

The ICTY's attempts at steering clear of claims of "victor's justice" are commendable, however, the reality of the Tribunal makes it impossible to enforce its statute without having some nation, or group of nations, hand over the indicted criminals.[253] States will only take the risk of arresting international criminals if they know they have the evidence to convict. Attempts at impaneling an impartial jury will not overcome the intense pressure to convict. Without each nation ceding jurisdiction to the ICC, it will be lost to the claims of victor's justice from those nations who expect the most from the court's ability to prosecute wrong-doers, those nations that are not strong enough to be the "victors.

253. *See* Penrose, *supra* note 233.

# THE KOSOVO CAMPAIGN: EXPLORING THE PROBLEMS OF INTERVENTION IN INTRASTATE WARS.

REVIEW BY JOHN D. BECKER*

LEGAL AND ETHICAL LESSONS OF NATO'S KOSOVO CAMPAIGN, Anduu E.Wall, (Ed.), International Law Studies, Volume 78, U.S. Naval War College, Newport, Rhode Island, 2002.

Kosovo stands as a symbol for many things in the world of international security affairs. First, it stands for intrastate war in a multi-ethnic society Second, it stands for the role of collective action by regional organizations in intrastate wars. And lastly, Kosovo stands for the problems of fighting in interstate wars by regional organizations. Accordingly, many recent texts have looked to Kosovo as a case study for modern war. Popular works like *Waging Modern Wars* by General Wesley Clark and *War in a Time of Peace* by David Halberstam are reflective here. More scholarly works are following in kind, including *Legal and Ethical Lessons of NATO's Kosovo Campaign,* edited by Anduu Wall.

Wall's text contains the proceedings from a scholarly colloquium entitled Legal and Ethical Lessons of NATO's Kosovo Campaign hosted by the Naval War College on August 8-10, 2001. The colloquium looked at the international and legal lessons to be learned from NATO's Kosovo conflict from the standpoint of *jus ad bello* concerns. In other words, consideration was given to issues relating to the conduct of hostilities, rather than the *jus ad bellum* questions regarding the legal justification of NATO's initiation of the air operation in Kosovo. A variety of scholars and practitioners participated in the colloquium including representatives from the Carnegie Council on Ethics and International Affairs, the Center for National Security Law at the University of Virginia School of Law, Duke University of Law School, and the United States Naval War College, as well as all the branches of the U.S. military and military allies from NATO to Israel and even Sweden and Switzerland.

The opening remarks by Vice Admiral Arthur Cebrowski, then-President of the Naval War College, are insightful in two regards. First, unlike many post-conflict conferences, Cebrowski notes this one is not focused on lessons learned, rather it is on lessons to be examined. The distinction is important in that only the future will show if the lessons have in fact been learned. Additionally, and

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probably more importantly, Cebrowski talks about the linkage information age and modern warfare. This nexus was first seen in the Gulf War and is now more in evidence in campaigns like Kosovo and Iraq war.

The information age has been characterized by three trends—networking, greater globalization and economic interdependence, and technology assimilation. Each of those trends, in turn, has enormous implications for societies and their militaries throughout the world. These changes have been analogized as significant as the change from the agricultural age to the machine or mechanical age.

Network-centric warfare most notable enables a shift from attrition-based warfare to a much faster effects-based warfighting style, characterized by operating inside an opponents decision loop by speed of command as well as by a change to the warfare's context or ecosystem. In theory, at least, the result may well be decisional paralysis.

It is forth noting here that network-centric warfare is the generational successor to what was called maneuver warfare in post-Cold war defense analysis. This movement, initially articulated by a group of young Turks in the Army and Marines in the late 1980's and early 1990's, challenged traditional military doctrine and standards and opened up the fields to extended discussion both within and outside the military profession. This author was exposed to this group of reformers and their ideas during an assignment to West Point at that time.

The approach itself is premised on achieving three objectives: first, the force achieves information superiority, having a dramatically better awareness of the battlespace; second, forces acting with speed, precision, and the ability to reach out long distances with their weapons achieve the massing of effects versus the massing of forces themselves; and third, the results that follow are the rapid reduction of the enemy's options and the shock of rapid and closely coupled effects in his forces. This disrupts the enemy' strategy and, hopefully, forecloses the options available to him.

Underlying this ability is an alteration in the dynamics of command and control. The key to this possibility is the ability to provide information access to those forces that need it most at the time they need it most. Traditional military notions of top-down command and control are replaced by new bottom-up executions and organizational structures. With that change, a number of challenges result form this new type of warfare and the text looks at three major ones.

They are found within the area of jus in bello and include: 1) targeting, 2) collateral damage, and 3) coalition operations. In fact, the text is broken into three parts reflecting these areas, framed by an introduction, by keynote speakers and a conclusion, looking to the road ahead.

Among the more interesting insights provided are those by conference speakers, the Honorable James R. Baker and Air Force Lieutenant General Michael Short. Baker, now a judge on the United States Court of Appeals for the Armed Forces, served as Special Assistant to the President and Legal Adviser to the National Security Council during the Kosovo campaign. Short, now retired

from active duty, served as the Commander of Allied Forces Southern Forces, and commanded NATO's Kosovo air campaign.

Baker argues that lawyers have a legitimate role in military operations, including in the vetting process of targets, targeting sets, and targeting in general. Lawyers, however, not always readily accepted in the military targeting team, for a variety of reasons including concerns about secrecy, delay, lawyer creep (analogous of mission creep, where one legal question becomes ten legal questions and which requires not one lawyer to answer but twenty lawyers to answer those legal questions).

Baker also forecasts three areas of tension between doctrine, policy and the law of armed conflict. The first of these, between Proportionality, Necessity and "Going Downtown, is the tension between the legal constraints of jus in bello and the military importance of striking hard at the start of a campaign to surprise and shock the enemy and thus, rapidly end the campaign. This was most recently seen in the Iraq War with the "Shock and Awe" campaign that kicked off the war. The second area is seen in dual-use targets, those targets which have both military and civilian objects, and accordingly the tension is found between effects-based targeting and the law of armed conflict. The attacking of convoys and bridges in Kosovo fell into this category. The third area is in the tension between the protection of noncombatants and the traditional understanding of military objectives. Specifically, this is expressed in the question of legally killing military (and political) leaders? This too was seen in the Iraq War with the decision to launch a missile attack against Saddam Hussein, based on intelligence reports which put him in a suburb of Baghdad. He concludes with the message that lawyers remain integral to the conduct of military campaign, particularly at the national command level, that the law of armed conflict is hard law, and that the application of the law armed conflict is a moral imperative.

General Short's remarks follows along the same topics Baker raises but his answers differ since his perspective is that of military commander—a professional soldier. And Short is clear about what he thinks here. Targeting is a shared responsibility but only in that the President and the National Command Authority should only be concerned with approving targeting sets—command and control nodes or power grids, for example. Individual targets that are not to be targeted should be put on a no-strike list. Once that is done, the commander and his forces should be allowed to get on with their mission and achieve the effects as rapidly as rapidly and with as little loss of life and as little destruction of property as possible.

The general also notes that anyone who understands anything about modern warfare knows that responsible commanders always take every possible step to limit collateral damage. But the job of a commander, and his staff of advisers, is to balance concern for collateral damage and concern for loss of life on the one hand with the risk you are asking your pilots to take. Citing an example from the Kosovo campaign, the bombing of a bridge outside of Nis, he notes that some Serb civilians were killed in an attack on the bridge. Milosevic quickly lined up the dead and brought down the international press from Belgrade to show off the dead. This had a CNN-effect on the Clinton administration and our NATO allies, resulting in unconscionable restrictions on bombing that target: only at night

between 10 p.m. and 3 a.m. and no bombing on weekends. The lesson taken away here ought to be that bombing, under any circumstances, is a difficult mission and putting unreasonable restrictions on that mission may limit civilian deaths but it also increases risks to friendly pilots, who are a valuable and limited resource. It may also encourage the enemy to take advantage of those imposed limitations and continue their campaigns of terror.

Finally Short acknowledges that while the United States should never undertake a military campaign alone—a lesson somewhat lost on the Bush Administration in the recent Iraq War—he also notes the difficulties involved in coalition warfare and military operations. Unlike the Persian Gulf War, where the norm was simply if your nation wanted to join the coalition of the willing, then you had to follow the coalitions' rules, it was different in the Kosovo campaign. Since NATO was an established regional organization that was fighting the war, albeit under U.N. Security Council resolutions, the decision-making process was set and accordingly, different. Each and every nation had to approve and agree on targets and target sets, to the point where a small nation member could effectively veto targets that a larger nation member might approve and want to strike. Likewise, some nations had much more restrictive guidance and other nations did not. The result was a complex targeting process, where specific state's military aircraft could be used on some missions and not others, where approval of bombing missions might be scratched in the air if approval was not granted in time, and where some restrictions applied sometimes and not other times, depending on where the combatants were in the timeline of the war (in other words, restrictions were less severe in the early days of the war than later in war, when they were much more demanding and controlling).

General Short concludes by noting that lawyers, particularly military lawyers, have an obligation to keep the commander within the bounds of the law, while conducting a military campaign. But, the job of the military lawyer is not to keep the commander from doing his job; rather it is to make it possible for the commander to do his job, without breaking the law, without blowing up things that shouldn't be blown up, without killing people who should not be killed, and without committing war crimes. And most importantly tell the commander the truth, even when he or she doesn't want to hear it.

Moving into the core of the book, Parts III, IV and V dealing with Targeting, Collateral Damage, and Coalition Operations respectively, a number of voices are heard. There is little agreement on all the issues but much insight to found. For example, Scott Silliman, a Duke University Law professor, notes while the precise linkage between jus ad bellum concerns and jus in bello concerns is not completely resolved, there is an important connection here. Whether one takes the 1950's view that the good guys, because they are good guys fighting a good war, don't have to follow jus in bello rules (which ultimately is problematic) or the more nuisanced view, that since self-defense is the only basis for lawful conflict, then the conflict must be measured by both jus in bello rules and if it complies with necessity and proportionality requirements of self-defense, the link between the two concepts is an overarching concern.

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Moore, to name but a few of the commentators here, discuss other issues like whether members of the armed forces of a party to an international conflict who find themselves in the power of the enemy are prisoners of war or not; whether it matters, in terms of legitimacy and the applicability of laws, if interventions are U.N.-based or regional-organizationally based; and whether the law of armed conflict always apply, regardless of the type of conflict or the parties to the conflict?

So it is clear that this text provides a broad and thorough consideration of the legal and ethical concerns of fighting modern war, specifically as viewed through the lens of the Kosovo campaign. It also suggests that the Kosovo experience can be most fruitfully used for scholars and practitioners. As Joel Rosenthal notes introducing the concluding section, we need to be able to see the choices clearly and be able to articulate the principles upon we make our decisions.

We also need to consider several inclusive legal and ethical issues stemming from rapid geopolitical and technological changes. These include recognizing that the law needs to keep up with those changes to be relevant, we need to carefully consider if we want to change that law from one focused on armed conflict to one focused on international human rights, and whether we can or even should try to learn lessons from history. These considerations will, hopefully, shed some light on the road ahead.

In sum, *Legal and Ethical Lessons of NATO's Kosovo Campaign* provides a nice summary of the difficulties found in waging modern warfare, including humanitarian interventions in intrastate wars, where jus ad bello concerns have become a dominant concern. It also helps us understand the difficult and complex nature of fighting war within the constraints of an established coalition and regional organization like NATO. One common criticism of U.S. action in the post-9-11 world has been its reliance on unilateral action. The problems and difficulties in fighting the Kosovo campaign suggest the other option—multilateral action—is not always the easy alternative to fighting wars.

Additional Comment:

Immediately after this review was prepared—March, 2004—fighting once again broke out in the Balkans. Erupting in the divided city of Mitrovica, clashes between Albanians and Serbs across Kosovo resulted in a handful of deaths and hundreds of injuries including U.N. peacekeepers. The U.N., according to reports by the *New York Times*, has lost control of several city centers throughout Kosovo. NATO responded by sending an additional 1,000 reinforcements to the already 18,000 troops in Kosovo.

Coming almost five years after the NATO intervention, the most recent clashes show at least two things. First, ethnic divisions in multi-ethnic states remain will remain for years and years, no matter the kind or type of interventions. Given that these divisions are often grounded in history and culture that extends for many generations prior to the present day it is sheer lunacy to assume that a few years of monitoring and controlling outward violence will change those divisions. Changing a culture—be it in an organization or a state—requires both strong leadership and long-term commitment, by the party desiring it. Second, the

relationship between the U.N. and regional organizations remains problematic in dealing with these kinds of conflicts. In past conflicts, there has not been the luxury of having regional forces available for almost immediate action. Somalia, Rwanda, and Haiti all come to mind as places where no regional organization was in place to work in conjunction with the U.N. In Kosovo, the U.N. is able to rely upon NATO to immediately deal with the problem of renewed conflict. But that reliance is not based upon communication and cooperative arrangements between the U.N. and the regional organization NATO. Rather, the regional organization deals with conflict as it sees fit. This is not the spirit or the intent of Articles 39-42 of the U.N. Charter, much less with Article 2(4), which is often considered the heart of the Charter.

Any long-term success in Kosovo is contingent upon recognition of these two factors and incorporation of them in the planning and executions of the operations for peace making and peace enforcement.